FINANCIAL ORGANIZATION
AND
MANAGEMENT OF BUSINESS

BY

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LOYAL FRIEND

BRILLIANT STUDENT

ABLE TEACHER

CONSUMMATE EXPONENT

OF INTELLIGENCE IN BUSINESS

PREFACE TO SECOND REVISED EDITION

In every printing of this book—and there have been fourteen in addition to the first printings of the original and revised editions—changes have been made to bring newly established principles and practices into the picture. In this second revision, like the first, a substantial portion of the book has been changed. More than 60 per cent of the 1932 edition has undergone some form of rewriting.

To keep the book within manageable limits, some outdated material has been deleted, and other material, now mostly of historical importance, has been summarized. The tables and examples have been brought up to date. In most instances references to companies or to issues of securities that have disappeared have been dropped, and new examples have been substituted. Government and other studies and reports have been drawn upon and cited. Because of the upheaval in the investment banking field, the chapter on syndicate underwriting has been completely revised. A number of chapters, particularly those on selling securities, on holding companies, and on reconstruction of corporations, have undergone substantial changes to give full effect to the following legislation passed since the revision of 1932:

Banking Acts of 1933 and 1935.
Securities Act of 1933.
Securities Exchange Act of 1934.
Public Utility Holding Company Act of 1935.
Social Security Act.
1938 Chandler Act amendments of Bankruptcy Act.
Trust Indenture Act of 1939.
Federal tax laws.

Many persons have been helpful in supplying information about changed practices. To all of them my sincere thanks is extended. I am especially indebted to Mr. David F. Anderson for his enthusiastic and painstaking assistance in the rewriting of the chapter on underwriting. I can best

express my appreciation of the continued interest and work of Miss Lillian Doris (she is too well known under that name to substitute for it her "after-acquired" name) by quoting an "anonymous" couplet with which Sir Walter Scott headed a chapter of one of his Waverly novels:

"The page he killed the boar,
The Knight he got the glorie."

C. W. G.

PREFACE TO FIRST REVISED EDITION

Since its publication, this book has been through a number of editions, each of which has contained a number of minor revisions. Because in the present edition it was planned to reset the type entirely, the author seized the opportunity to bring all the material up to date

The use of new devices in corporate financing has involved the enunciation of new principles and has required an explanation of those devices and their effects. New illustrations have been added and many of the old illustrations have been either eliminated or revised in such a way as to reflect later practices and later results. The total net addition to the book amounts to over 100 pages.

The general outline has been preserved, and those who are familiar with the old book will have little difficulty in discovering the additions.

I am again indebted to Miss Lillian Doris, who has been untiring in her assistance.

Dr. Harry G. Guthmann, Professor at Northwestern University, an old colleague and a constant friend, has, in the course of his teaching, come upon a number of instances where improvement could be made in the text. I have incorporated his suggestions in the second printing of the revised edition, and I take this opportunity gratefully to acknowledge my indebtedness.

C. W. G.

PREFACE TO FIRST EDITION

This book is practically the course in corporation finance as it has been given for a number of years at the School of Commerce, Accounts and Finance of New York University. The aim in teaching the course has been to give the alert, capable student a thorough training in the subject, by which is implied breadth of information and depth of insight into the underlying principles. I am convinced that a course in the subject of business finance based on this book and vigorously pursued can be trusted as a modern substitute for some of the college mathematics, logic, and philosophy of a generation ago

But in preparing the manuscript I have tried to keep in mind the casual reader and the business man who may care to use it as a reference I have tried, therefore, to make the information exact, to show the "how" as well as the "why," and to leave no loose ends in the telling The persons I have in mind will, I trust, be grateful for the charts.

The writing of this book, and especially its completion, was done under great difficulties. The shortcomings are thus explained if not excused. Day by day, as the work made its slow progress, I was forced to marvel anew at the loyalty of the friends who helped and the kindness of utter strangers to whom I made appeal for assistance. I wish I could recall these names and record my deep appreciation. Surely in the business life of America today one meets universal kindness and helpfulness that put misanthropes to shame.

I must give special credit to my old student and present colleague, Raymond E. Bagley, who has drawn all the charts. Messrs. Joseph H. Bonneville, Edward D. Arnold, Thatcher C. Jones, and Professor David F. Jordan, all of the Faculty of the School of Commerce of New York University, have given helpful criticisms of parts of the manuscript. Miss Lillian Doris has done so much work on the book, intelligently, patiently, and loyally, that I seem selfish in not adding her name as a co-author.

CHARLES W. GERSTENBERG.

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CHAPTER I

PROMOTION—
THE WORK OF THE PROMOTER

Scope of book.—When a business man speaks of finance, he may have one of two ideas in mind; he may be thinking of the way money is coined and how funds are created by banks to be exchanged in foreign and domestic banking, or he may be thinking of how individuals and corporations obtain and use funds and distribute the profits derived therefrom. The former idea carries one naturally into the field of banking; the latter into the field of business finance. In this book we shall study the latter idea: how businesses are organized to acquire funds, how they acquire funds, how they use them, and how the profits of the business are distributed. We shall have to consider also what happens to a company when it has insufficient funds or when its operations result in losses.

The relation of finance to other branches of business.—Finance is intimately related to the other branches of business, namely, production, marketing, and accounting When production is inefficient, funds will be wasted, if, indeed, they can be attracted at all by the inefficient concern. The principles of marketing will have to be drawn upon by the financier, first in studying whether to engage funds in a given enterprise, and second, in discovering how to market stocks and bonds. Accounting is intimately connected with finance, for the financial manager must rely upon the accuracy and scientific arrangement of the records of a company to guide him in managing the in-flow and out-flow of funds. In this book, therefore, it will be necessary at times to refer to principles of production, marketing, and accounting; but only so much of these subjects will be drawn upon as is essential for the study of finance

Promotion.—Promotion is the first step in finance. Promotion may be defined as the discovery of business opportunities and the subsequent organization of funds, property, and managerial ability into a business concern for the purpose of

making profits therefrom. A man with funds is master of many people's destinies. By contributing to this enterprise or to that, he dictates which of the public's desires for goods or services shall be realized. This responsibility is a great one and is committed by most sensible people to investment banks, whose business it is to investigate enterprises calling for funds to see whether they will serve a public demand urgent enough to earn a return sufficient to pay all operating expenses, interest on the capital invested, and to yield, in addition, a profit that will encourage the managers to carry on the business with the utmost efficiency. Investment bankers, however, do not initiate enterprises. They simply investigate them and decide whether or not funds shall be invested in them. They are promoters, however, in the sense that frequently they are makers of mergers.[1] The original idea of the business, if it is a new one, arises in the mind of a promoter. It is the work of the promoter to search for new public demands and to find means of satisfying them. Frequently, the promoter will carry his work beyond the stage of promotion and undertake to conduct the promoted business. Such men are really entrepreneurs who promote their own enterprises. The out-and-out promoter, however,—a man like Charles R. Flint,[2] who promoted the American Chicle Co., and a number of other companies—ordinarily does not interest himself in managing the business after it has been promoted. For the present, we shall confine our attention to promotion pure and simple and to the work of the promoter as such.

The promoter and competition.—A promoter may undertake to launch an enterprise because he feels that some other concern is making monopoly profits or conjunctural profits, a part of which he can share. Every time a new business is started in a field in which there are already competitors, we have an illustration of this form of promotion. The promoter ought to be well assured that there are some available monop-

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[1] During the merger era of 1920–1930, consolidations were promoted by officers of corporations, members of investment banking firms, lawyers, industrial engineers, and commercial bankers, as well as by professional promoters. For names of men prominent in consolidation promotions during the period mentioned, see a series of articles entitled "An Outline of Mergers," by John Allen Murphy, which appeared in *Sales Management and Advertisers' Weekly*, issues of Oct. 27, Nov. 10 and 24, Dec. 8, 22, and 29, 1928, and Jan. 12, Feb. 2 and 16, and Mar. 9 and 30, 1929.

[2] See his "Memories of an Active Life."

oly or conjunctural profits. If, however, his purpose is to promote a concern to earn what the economists call "pure profits," he must be reasonably sure that the standard of efficiency of those already in the field is so low that a new concern will be able to produce at a lower cost, for it must be remembered that every new concern that enters a given field of production increases the available supply of products and thus tends to bring down the price of that product.[3]

On the other hand, the promoter may seek to eliminate competition through the consolidation of several competing units. During the period of the formation of the industrial trusts, say from 1880 to 1903, and during the more recent period of the creation of large business units, say from 1915 to the present day, promoters have found their largest profits in this form of promotion work.

Economic function of the promoter.—The successful promoter makes large profits, so large indeed that it is sometimes thought that he is overpaid for the services he renders. The fact is that he not only takes huge risks but that he performs unusually valuable services for the public. In an action brought against Thomas F. Ryan by Harry Haskins, a promoter, the latter stated in his complaint that he had spent $50,000 in investigating the feasibility of consolidating a number of independent lead plants and in obtaining options on those plants.

An engineer's report on a projected interurban railway or electric light and power plant and distributing system may easily cost as much as $10,000 or more, and the result of the report may be to show that the project is not feasible. There is a well-known engineering firm in this country whose specialty it is to investigate patents for new inventions to see whether the patents are secure against infringements and whether they are commercially exploitable. We are told that a fee of from ten to fifteen thousand dollars to ascertain the business value of an automobile accessory is not unusual. In another case a promoter spent $30,000 for investigations, plans, and like material preliminary to the organization of an engine works. All such expenses are paid by the promoter, and if his investigations prove the inadvisability of such an undertaking—as

[3] The reader who is unacquainted with economic theory will do well to read the chapter on profits in Ely and Wicker, "Elementary Principles of Economics."

they did in the case of the engine works—the entire cost is borne by him as a loss.

The promoter performs a public service whenever he produces a successful concern.[4] As we have seen, he either creates a new demand that helps us to do our business more readily, or to live more comfortably, or he supplies older utilities in a cheaper way, or he saves the ruining wastes of competition with its long trail of duplications, unnecessary advertising, and similar extravagances.

The promoter has been much maligned. He is not a prestidigitator. Rufus Wallingford no more represents the real type of promoter than Sherlock Holmes represents the true type of detective. The true promoter may have his moments of elegant ease, but he knows what real work is. We are told that one of the best-known promoters in this country had a load of mules on board ship on the way to Europe in 1914 a few days after the declaration of war. You can imagine how this man worked night and day in getting the contract and in filling it. As we shall see, the promoter's work of discovering, assembling, and financing is a matter of close attention to details.

Steps in promotion.—The promoter accomplishes his purposes in three distinct steps: first he makes the discovery of the idea, then he assembles the elements of the business, and finally he procures the funds to put these elements into operation.

Discovery.—A promoter makes a discovery when he determines that an opportunity exists for exploitation. The opportunity is at this stage a mere idea which may involve the creation of a new demand or the satisfaction of an old demand that is not yet well or completely satisfied. For example, when the United States entered the World War, a demand for

[4] This statement assumes, of course, that the concern brought into existence by the promoter's efforts does not abuse the interests of investors, of consumers, or of the general public. Unfortunately, the promotion of many large public utility holding companies and other combinations in the decade from 1920–1930 was marked by persistent and widespread disregard of public interest. This condition was revealed especially in the Congressional investigations which culminated in the passage of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Act of 1935. While this legislation has helped considerably to check unscrupulous practices, Government reports based upon investigations made by the Securities and Exchange Commission subsequent to the enactment of the laws mentioned indicate the need of and make recommendations for further legislation to protect investors.

"service" flags was created by the invention of the "service" flag, and it is safe to say that this idea meant thousands of dollars not only to the inventor, but to a great many other people who were in the business of making flags or who went into that business. On the other hand, there has been in existence for some time a demand for a simple method of wrapping up bundles, and the man who first conceived the idea of using gummed paper tape was at the moment of discovery a promoter. Frequently, an idea is refined by future promoters.

Steps in discovery.—As was intimated in the previous paragraph, discovery is essentially a matter of investigation. The idea itself may come as a flash to an inventor; it may be an inspiration on the part of some people engaged in a similar business to expand into a somewhat new field, or it may painfully develop in the minds of competitors who see in it an escape from the ruin that a continuation of competition will entail. A familiar example of the last of these is the threat of Carnegie to go into the semi-finished steel products industry to forestall the plans of Morgan, who was taking steps preparatory to going into the iron ore industry. But the feasibility of the idea must be investigated by a person whose training and experience fit him to weigh impartially all the elements of advantage and risk that lurk in a projected enterprise. In the very nature of things, a person who has conceived an idea usually is an optimist and an enthusiast; his viewpoint is warped by prejudice. It would be much better for him to turn over his idea to an impartial investigator, a trained promoter who can weigh the elements that will have to be taken into consideration in making a fair forecast as to whether the enterprise will be profit-making or not. It will be seen, therefore, that the mere conception of an idea is not all there is to discovery. This step in promotion includes not only conception but investigation; and this latter process may again be divided into three steps, of which the first is a rough estimate, the second, a detailed investigation, and the third, checking up or verification.

A rough estimate.—Let us suppose that an idea is brought to you and that you are asked to promote it into a business enterprise. You will first inquire who originated the proposition, and in obtaining the answer to this question you may save much unnecessary labor later, for the unlikelihood of a

feasible idea coming from an incompetent person is so great that the first rule of the promoter is that a proposition must be properly sponsored. An example of good sponsoring could be found in the case of a bright young man who has had experience in the line of business and sees improved methods in that line which do not appeal to his old-fogy employers.

The promoter will then seek to determine the basic idea in this business. Is it a manufacturing or a marketing idea? Does it satisfy an old want in a new way, or does it depend upon the stimulation of a new demand? The promoter, it will be seen, should be a man of wide experience who can sense the possible value of new ideas and reject without laborious investigation those which are palpably defective. The aim of this first step should be to determine whether it will pay to spend the time and money necessary to make a detailed investigation.

Who makes detailed investigation.—At this stage of his inquiry the promoter will have no more than a "hunch" that he is on the track of a profitable idea; but it will not pay him to spend his time or to risk other people's money in testing out in actual operation the value of a "hunch." He must make, or cause to be made, a detailed investigation. The cost of this investigation is comparable to an insurance premium. It costs money, to be sure, but it is a protection against a much larger loss.

If the enterprise is one that involves difficult production problems, investigation will be carried on chiefly by an engineer. If it depends for its success upon the possible existence of a demand and the discovery of a proper method of reaching that demand, the services of a marketing analyst should be secured. If, on the other hand, the promotion is in the nature of a consolidation, the investigation will be carried on chiefly by accountants and appraisers whose business it is to determine the values of the constituents of consolidation. Additional specialists may be required, such as chemists, patent-lawyers, and others.

Scope of detailed investigation.—For the present we shall not consider the promotion of consolidations. The analysis of a projected new enterprise from the standpoint of the promoter may be divided into three parts: first, the computation of the capital cost; second, the estimate of probable gross revenue; and third, the calculation of the operating costs. These

three steps may be stated in another way as follows: will the projected enterprise take in enough to pay the costs of operation, pay interest on the capital invested, and leave sufficient profit to compensate the owners for their risks and their services?

The capital costs.—Money will be needed for the capital assets—so-called—of any enterprise. Not only are the land and buildings, the machinery and fixtures, and the raw materials to be acquired, but also a certain amount of working capital is necessary to get the operations started and to keep them running smoothly. The amount of capital funds required will depend on the nature of the business. A public utility such as a gas company or a telephone company will require much more in proportion to the size of its business than a simple trading company. Then there is to be taken into consideration the proposed scope of the projected business. It may be desired to start out on a large scale or it may be thought wise to begin in a small way and to expand the organization gradually out of profits. Finally, there is the problem of whether all branches of the business are to be carried on or only a few. For example, it is possible to start in the cotton goods business, and to operate only the function of buying the product and reselling at a profit. The production will be done by an independently owned mill, and the accounting, financing, and collecting will be done by a fiscal agent.

Determining scope of enterprise.—At the outset, then, after the nature of the business is determined, and before the capital to be raised can be estimated, the projectors will have to determine whether they want to start on a small scale and gradually expand, or whether they want to start full-fledged. Where a large-scale business is contemplated, the underlying motive is usually the timeliness of the project. To get the market when it is just right is a great advantage. But certainly there are many disadvantages in trying to build up an organization with money only and without regard to the element of time. Mistakes are sure to be made and these will be costly in proportion to the size of the business. The personnel of the concern will be difficult to handle, especially as compared with an organization where the different grades of responsibility are gradually consigned to men whose ability to shoulder responsibility has been tested. In short, the

full-fledged, full-panoplied proposition is likely to be a forced hot-house plant.

Next, the projectors must determine whether or not the product is to be marketed only, or is to be manufactured as well as marketed. Some very prosperous concerns have been built up on products produced outside the business itself. Such concerns, for example, are the mail order houses. The options that are open to a projector are more numerous than is generally suspected. (1) The concern may do its own manufacturing with its own machinery, either (*a*) buying the plant or (*b*) leasing it. This method of conducting the business gives the concern the manufacturing as well as the selling profit, insures uniformity in quality and quantity of output, and holds out the possibility of meeting competition through reduction of manufacturing costs. On the other hand, profits may be cut down through such contingencies as strikes and fluctuations in costs of material, the manufacturing effort may be great compared with the selling effort, while the profits from the former may be relatively small and the time and effort required to get the manufacturing started may preclude large profits that could be obtained by getting to the market immediately (2) The concern may contract to have its product manufactured for it, (*a*) owning none of the machinery, or (*b*) owning the patterns and special tools. The arguments for and against this plan are about the reverse of what they were for plan 1. (3) The concern may contract for the manufacture of its product but may itself buy most of the raw material, thus saving the buying commission, which in the case of paper in publishing concerns is usually about 10 per cent. Moreover, this plan insures steadiness of output in times when materials are scarce. (4) The concern may assemble its product, and may (*a*) make none of the parts, or (*b*) make some of the parts. Many automobile concerns use outside parts almost exclusively and probably few, if any, of the manufacturers in this country make the entire automobile. The problem here hinges on large-scale production. One concern, for example, may not require enough axles to enable it to produce them in large quantities and thus get the benefits of large-scale production.

The reader can easily determine for himself, with but little consideration, which of the methods of operating a concern will require the greatest amount of initial capital.

Factors that enter problem of home and outside production. Very briefly we shall outline some of the general questions that must be considered by the projector in determining which method of manufacturing shall be chosen.

1. *Difficulty of raising capital.*—Where the project is inherently so small or of such a nature that the usual channels for raising money cannot be used or cannot be used profitably, and where the promoters have not the necessary financial connections, the method that requires the smallest initial outlay will usually be chosen.

2. *Load factor.*—In order to manufacture its own goods, a concern may have to buy a considerable amount of machinery only part of which can be used steadily. These part-time machines will be charged with interest twenty-four hours a day and three hundred and sixty-five days in the year. They may produce income only 50 per cent or even only 10 per cent of that time In such cases it may be better, till the business has grown, to contract for the manufacture of the product with some other concern which through other similar contracts enjoys the benefits of large scale production.[5]

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[5] This problem of the load factor is only beginning to be understood. In commenting on the success of the six-hour day of the famous Leverhulme plant in England, H K Webster explained the situation thus:

"You are a manufacturer The labor cost of the thing you make is one dollar, and the overhead, on the basis of the eight-hour day, is one dollar That is to say, the interest on the capital invested, rent of premises, depreciation, taxes, salaries of executive officers—all expense, in a word, that does not increase as the volume of the product increases, works out, when you divide it up by the number of articles you make on an eight-hour, one-shift basis, to as much per article as the wage of a man while he is making one. In this case, one more dollar So the total cost of the article, outside raw material, is two dollars

"Now you adopt the six-hour day with two shifts You pay the worker his four dollars for three articles instead of for four Another worker then comes on and you pay him the same At the end of the day you have six articles instead of four, but you have paid eight dollars for them. Now add in the overhead That remains constant at four dollars, since it does not increase with the increased production Four dollars, then, added to the eight And a gross cost of twelve dollars for six articles, where, on the other basis, you had a gross cost of eight dollars for four articles So it comes to the same thing? By no means You've been selling those articles at a profit, haven't you? Say of fifty cents You have an output now—without increasing your investment in plant—of six as against four. A profit, therefore, of three dollars as against two.

"And we're not at the end of our tether yet, either. If two shifts, why not—if the demand warranted—three? A shift going on at 8·30 p. m. and coming off at 2·45 a m Inconvenient hours, rather, but it would be only one week in three that you would have it to do. How does that work out?

3. *Hazard of the experiment.*—If there is any danger that the marketing at a reasonable price will be difficult, the experiment should be tried with a minimum of invested capital.

4. *Secrecy of quality.*—Where the enterprise depends for its "selling point" on superior quality, the business will likely have to manufacture its own goods In practice this point is probably less important than it seems. Certainly in the standardized—so-called—brands of canned foods and toilet articles many concerns boast of quality though they have little to do with the direct production

5. *Intricacies of the business.*—Where one department is likely to interfere with another, the most profitable part, usually the marketing, will probably be retained and the other department omitted. Thus, comparatively few publishers print their own publications.

Labor cost for the three shifts, $12 Overhead, $4 Total, $16 And you have nine articles at the former gross cost of eight And nine articles to make a profit upon as against four under the old system " From "Lord Leverhulme and the Six-Hour Day," *Metropolitan Magazine*, July, 1919

CHAPTER II

PROMOTION—METHODS OF INVESTIGATION

Methods of making investigation.—Having now considered the broad problems that arise in determining the amount of funds that will be required, we may turn to a consideration of the three methods of investigating specific enterprises; that is, the methods that are used in estimating probable capital requirements, probable gross earnings, and probable operating costs. These three methods may be stated to be the statistical method, the canvassing method, and the comparison method.

In the statistical method, units are devised and all calculations are made on the basis of those units.

The canvassing method does not use abstract units; actual estimates are made of the cost of building the proposed plant, and a survey is also made of the particular field that is to be served by the products of the projected company.

The comparison method involves study of the balance sheets and income statements of companies which do work similar to that of the projected company, and which are of about the same size.

What funds are required.—Before showing the exact methods of estimating the amount of funds required for a new concern, it seems advisable to classify the purposes for which funds for the new business will be needed, in the following way:

1. Promotion expenses.
   - *a* Preliminary investigation of the project.
   - *b.* Assembling parties who may be willing to participate.
   - *c.* Preliminary engineering, legal, accounting, and marketing advice.
   - *d.* Estimates of costs, income, and expenses.
   - *e.* Procuring options.

2. Organization expenses.
   a. Incorporation of the company.
   b. Expenses of keeping corporate organization going until company begins operations.
   c. Taxes and interest due before company begins operations.
   d. Miscellaneous legal and accounting expenses.
3. Cost of fixed assets
4. Cost of establishing the business, which covers all expenses, including canvassing and advertising for business from the time the company begins operations till its income is sufficient to meet expenses.
5. Regular working capital.
6. Financing, including banker's commissions, costs of preparing and filing registration statements under the Securities Act of 1933, if there is to be a public offering of securities in more than one State, and promoter's profits.[1]

In estimating the total amount of funds necessary for these six purposes, the investigator will not necessarily follow throughout one of the three methods mentioned in the previous section. He will, perhaps, use the statistical method for estimating the promotion expenses and the cost of establishing the business, the canvassing method for estimating the cost of fixed assets; and for the remaining items he may use the comparison method.

Importance of detailed classification.—This classification may seem to be extraordinarily detailed and applicable only to large enterprises. The fact is that it is important in the smallest as well as in the largest projects. Some of the items, to be sure, may be very small, but this statement is likely to be true only *absolutely* and not *relatively*. At any rate, the promoter entering upon any project will do well to use a table like that contained in the foregoing paragraph no matter what undertaking he has in hand, for then he will be less likely to fall into the grave error of making his estimates too low. This, after all, is the great danger against which the promoter must guard. The promoter is an optimist; he would like to see his concern launched with a small initial outlay, for in that way

[1] *See Elements of the Cost and Value of a Gas Plant*, C. W. Gerstenberg, "Materials of Corporation Finance," page 455.

his enterprise will better engage the interest of capitalists. But there is a fundamental rule of finance that the last dollar is always the most valuable dollar If $100,000 has been invested in a concern and $10,000 more is needed, the people who furnish the final $10,000 are likely to demand as large an interest for their money as those who furnish the first $100,000. Without the last $10,000, the first $100,000 will become worthless. The promoter then must see to it that his estimates are ample and that no money is tied up till the full amount is in sight.

Statistical method of calculating capital requirements.—We are now ready to explain the methods of calculating the capital requirements of a new concern. In the statistical method the various elements of outgo are broken up as far as possible into uniform units After the cost of each unit is estimated and the number of units of each kind that will be needed is ascertained, it is simply a matter of mathematics to arrive at the total cost.

1. *Promotion expenses*—The statistical unit that can best be used in calculating the promotion expenses is probably a unit of time. All the promotion expenses can be reduced to a matter of paying the promoter and his engineering, accounting, and marketing experts for the time required to make their investigations. Some money probably will have to be given in a lump sum to bind the options, such as an option on a patent, but frequently even the consideration for the options will be the promoter's promise to undertake and prosecute the promotion of the company. An estimate on the statistical basis of the promotion expenses of a concern to exploit a patented automobile accessory, to be sold but not manufactured, would appear as follows:

Promoter's expenses, including preliminary investigation, engaging experts, assembling, etc, 100 days at $50 a day	$5,000 00
Engineer's report on validity of patent and feasibility and economy of patented device, 10 days at $100 a day	1,000 00
Commercial analysis of proposition by marketing analyst, 20 days at $25 a day	500 00
Total	$6,500 00

2. *Organization expenses.*—In the same way the organization expenses may be estimated as follows.[2]

Incorporation of company

Filing fees	$40 00	
Organization tax, $1,000,000 capital stock at 50c per $1,000	500 00	
Lawyer's fees, 5 days at $100 a day	500 00	
Legal expenses, stenographer	20 00	
		$1,060 00
Office expenses for 8 weeks, at $40 a week for clerical help, and $75 a week for manager		920 00
Rent of office for two months at $75 a month		150 00
Miscellaneous expenses, stationery, telephone, etc		80 00
Total		$2,210 00

3. *Cost of fixed assets*—We shall assume here that the company is merely to sell its product and is to have it manufactured by a contractor. This will simplify our procedure while we are making a general survey. Later we shall take up in detail the problem of estimating the cost of fixed assets. Our present estimate, therefore, need include only office furniture, the actual cost of preparing the patent papers, and legal expenses incidental to getting the patent [3]

Patent.	$225 00
6 desks at $45	270 00
2 typists' desks at $45	90 00
3 filing cabinets at $35	105 00
2 typewriter machines at $100	200 00
2 tables at $40	80 00
12 chairs at $7 50	90 00
2 rugs at $50	100 00
Total[4]	$1,160 00

4. *Cost of establishing the business.* - In large enterprises, such as public utilities, the cost of establishing the business gives rise to the capital asset known as "going concern value." In a well-known rate case, the New York Court of Appeals defined "going concern value" as follows· "I define 'going value' for the rate purposes as involved in this case to be the

[2] These expenses run from the time an office is engaged until the company is organized, the funds are raised, and the company begins operations.

[3] It is assumed that the company is to pay the expenses of getting the patent, and that in addition stock will be given the inventor for his invention. Additional stock will be issued to the promoter for his services Hence the capitalization of the company is $1,000,000

[4] Other equipment may be required later, such as an addressograph, check protector, multigraph, etc., but at the outset these devices can probably be dispensed with.

amount equal to the deficiency of net earnings below a fair return on the actual investment due solely to the time and expenditure reasonably necessary and proper to the development of the business and property to its present stage, and not comprised in the valuation of the physical property." The value of "going concern" may be represented as shown in the following diagram.

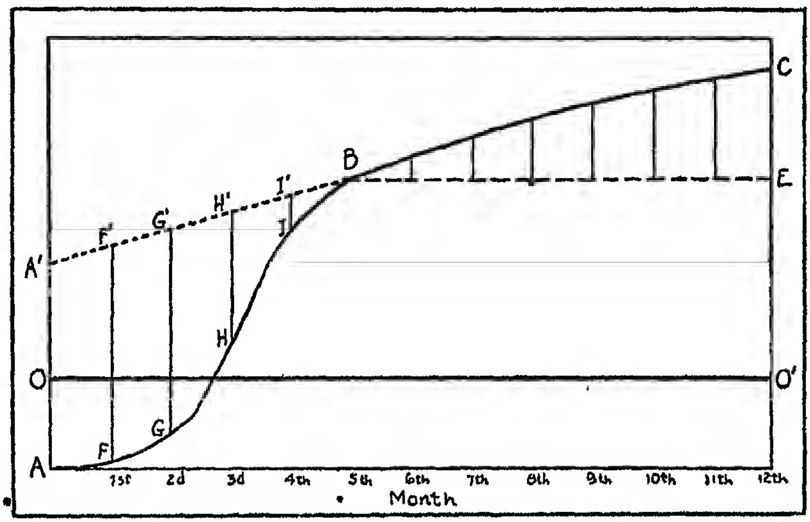

Chart Illustrating Measurement of Going Concern Value and of Goodwill

A, B, C is the line of net earnings. The vertical lines mark off months during which the business is in operation. When the net earnings reach *B*, at the end of the fifth month, they have reached the normal; thereafter they increase with the normal increase in general business in the industry. If we carry this trend line backward to A^1, we shall find what would have been the normal earnings over this period if the company had had its business fully established. The sum of the amounts represented by the distances FF^1, GG^1, HH^1, and II^1 is the value of the company's "going concern." It is the deficiency of earnings that every company must face in overcoming the inertia of getting established.[5]

[5] We may use the same diagram to illustrate what is meant by the term "goodwill" If the distance between the line OO^1 (the base line of nothing) and the line *BE* represents the net earnings necessary to pay a fair return on the stock of the company (or more correctly the owner's investment), then the distance between *BC* and *BE* capitalized will equal the company's

This is all very well, the reader will say, to value the intangible asset known as "going concern value" after it has been established, but our problem is to estimate at the outset what it is going to cost to develop the business. The objection is well taken; the explanation given above was intended as a definition of "going concern value," rather than as a method of determining how much it costs to acquire the latter. We shall return to our simple enterprise, the development of the business of marketing a new automobile accessory, and attempt to determine the cost of going concern value in this case. The marketing expert's analysis of the feasibility of the enterprise will probably include a plan for marketing, with estimated costs, and a statement of the time it will take to bring cash income up to cash outgo. We may assume that for the sixth month after operations begin, and thereafter, sales can be made to yield a gross profit of $5,000 a month. The total development costs, or costs of establishing the business, may be summarized thus:

Rent for six months		$450 00
Stenographic and clerical help, per week—		
Two stenographers	$55 00	
Bookkeeper	35 00	
Manager	100 00	
Salesmen's drawings	250 00	
	$440.00	
Twenty-five weeks at $440 per week . . .		11,000 00
Advertising, magazine (about 800,000 circulation spread over six months at $2 50 per M)		2,000 00
Circulars and mailing same, 200,000 at 6 cents		12,000 00
Miscellaneous expenses, including stationery, telephone, general office supplies, at $50 per month		300 00
Total		$25,750 00
Less expected revenue, as follows		
Sales second month, 100 at $2 50[6]	$250 00	
Sales third month, 300 at $2 50	750 00	
Sales fourth month, 700 at $2 50	1,750 00	
Sales fifth month, 1200 at $2 50	3,000 00	
Sales sixth month, 2000 at $2 50 .	5,000 00	
		10,750.00
Net amount of funds required to start business and run it till income will take care of outgo ..		$15,000 00

goodwill. While "goodwill" is usually entered on the balance sheet at a definite amount, theoretically its value varies with the fortune of the concern.

[6] The $2.50 represents the total income per unit of product less the cost of manufacture.

5. *Regular working capital.*—We shall discuss in a separate chapter the problem of the funds required for regular working capital. Here our problem is to discover how much funds the company ought to have at the outset beyond the amount required to establish the business. Some margin of liquid capital will be required for contingencies and to give the company a good credit standing.[7]

In our supposititious case we can assume that an opening inventory of $5,000 is adequate, that goods are sold on thirty days' credit, and that the manufacturer gives the same credit. A fair estimate for regular working capital for this concern would be about a month and a half's operating expenses. These we found above to be $25,750 for six months; the amount required therefore would be about $6,500 plus $5,000.

6. *Cost of financing.*—We must pause now to see how much money will have to be raised. Our summary will be as follows:

1 Promotion expenses	$6,500 00
2 Organization expenses	2,210 00
3. Cost of fixed assets	1,160 00
4. Cost of establishing business (net)	15,000 00
5 Regular working capital and inventory	11,500 00
Total	$36,370 00
Add for contingencies, 10 per cent	3,637 00
Total amount of cash to be raised .	$40,007 00

The sum of money to be raised is comparatively small. Probably no investment banker with an established business and clientele could afford to handle it as a proposition to be dealt with as are larger propositions. It may be suggested that the promoter ought to be able to raise the money. Strictly, this is not his function. His function is to discover a project, assemble an organization, and arrange for its financing, but the last step is accomplished in large concerns through the aid of an investment banker. In a proposition as small as this the promoter may well undertake to raise the money himself. In so doing, his expenses, including commissions that he may have to pay intermediaries, may amount to from 10 to 15 per cent of the amount raised. It would be necessary for this concern, therefore, to have from $44,000 to $46,000.

[7] In view of the more complete discussion of working capital (see Chapters XXIII–XXV) the discussion here is very brief

If the sum needed had been in excess of $100,000, the promoter might have found some security house willing to handle the sale of stocks to yield this amount. But such houses are rare. They will hardly be found in New York, where the investment houses have discovered, according to the best information we have been able to obtain, that an issue of less than $1,000,000 is unprofitable. Or the promoter might hire an experienced salesman to "peddle" the securities. Cost of selling securities of an issue of less than $1,000,000 will be about 25 per cent of the amount raised.[8] The regularly established security houses may be interested in large concerns requiring more than $1,000,000. Their charges and disbursements will run, for a new concern, from 1 or 2 per cent of the amount to be raised to 25 per cent, depending on the size of the issue, on the nature of the enterprise, and on the people who are behind it.

In addition to the costs indicated, if the issue offered to the public exceeds $100,000, the expense of preparing a registration statement and prospectus to meet the requirements of the Securities Act of 1933 will have to be met, unless the securities are sold only to persons resident within the State in which the corporation is organized and does business.[8a] In the latter event the issue is exempt from the Act.

Another example of estimates of cash required. In the preceding example we carried through the calculation for a relatively small concern and we used the statistical method. Let us now see how the second method of investigation, the canvassing method, can be applied to a larger concern, whose demand for fixed assets is large because it is to do its own manufacturing. We may in fact take an interurban railway. The following figures are in part a summary of an actual engineer's report.[9]

General scope of the proposition.—The first problem of the promoter is to decide just what he wants to do. Shall his road run from X to Y or continue to Z, or shall there be a

[8] See the complete discussion in the chapters on selling securities (Chapters XX–XXI).

[8a] For estimate of expenses involved in complying with the Securities Act of 1933, see footnote 13, page 368.

[9] The original report is printed in full in C. W. Gerstenberg, "Materials of Corporation Finance," pages 457, *et seq.* Although that report is now somewhat old, the method is unchanged. The figures as they are given for 1906 may be used, since costs are now variable and any reasonable figures may be used to illustrate the method.

branch line from *M* on the road *XY* down to *A*? The problem here is very much the same in its parts as in its entirety: will the extra capital outlay be justified by the business possibilities of the extension?

We cannot go into all the detail, that is an engineer's job. All we can do is to explain what the promoter can expect the engineer to do. The promoter himself, or his associates, will have made, we shall suppose, the rough estimates which have justified him in procuring his franchise and the necessary options on the right of way [10] The engineer will then survey the ground and determine what the construction problems are likely to be. To this end he will divide the entire length of the line into parts, each of which presents rather distinct problems. In the report which we are considering, and which may serve as a guide, the entire road was projected to connect three cities, of which Lima and Marion, both in Ohio, are about 55 miles apart, while the third city, Kenton, is about midway between them. The entire route was divided into six sections, numbered for convenience from 0 to 5, of which the shortest section was the first, 2.17 miles, and the longest was the fifth, 14.77 miles The construction of the roadway was divided into sixteen elements as follows:

a Clearing and grubbing ·All cutting of trees and underbrush, and removing of stumps along right of way

b. Excavation and embankments All earth work to subgrade.

c Bridges All plate girders, steel trusses, and wooden trestles

d Concrete All masonry in wall or arch for culverts and abutments for steel spans.

e. Ballast All cost of material, loading, transportation, and placing

f. Rails All "T" and girder rails and special work in main track, sidings, and switches

g Spikes All used in main track, sidings, and switches

h. Splices and bolts· All used in main track, sidings, and switches

i. Ties All used in main track, sidings, and switches

j Track laying and bonding All labor connected with this part of construction.

k Fencing. All cost of one line on private right of way paralleling roads; two lines where passing through property.

l Highway crossing All cost of cast iron pipe in place

m. Culvert pipe All cost of cast iron pipe in place.

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[10] In the case of any utility the preliminary survey would include a consideration of competition and of supporting population The American Investment Bankers Association has pointed out that a public utility security does not present a sound investment unless the utility will be supported by a population of 500,000

n Bonds and cross-bonds. All cost of 0000 copper bonds in place under splice bar and cross-bonds every 500 feet

o Platforms and shelter houses All cost of stations along line

p Repaving All cost of taking up and relaying pavement in Kenton and Marion

How capital investment is estimated.—In a preliminary statement some of the essential features of the nature of the construction are explained; as, for example, that "rail, along private right of way, is to be 70-pound standard tee rail, joined with four-bolt splice bars. Through village streets it is intended to use 9-inch 95-lb girder rail."

The report then proceeds to examine each of the six sections and to estimate separately the cost of each of the sixteen elements. A summary brings together the costs of the six sections. The power plant and stations are described and their costs estimated. The total cost of the sections, of line construction (that is, poles, overhead wires, insulators, and so forth), of buildings, power plant, substations, and rolling stock (passenger cars, combination passenger and freight cars, freight cars, locomotives, work cars, and flat cars) is estimated at $1,198,626. To this is added "for supervision of construction, engineering, contingencies, and first year's carrying charges," 7 per cent of the total, or $83,904, making a total estimated capital investment of $1,282,530.

Canvassing the territory to estimate probable gross receipts.—The second step in investigation, we saw, is the estimate of gross income. We shall now describe this step and incidentally illustrate what we have termed the canvassing method of making an analysis—that is, making a survey of the particular field to be covered.[11]

In the report on the interurban railway, after the engineer has made his estimate of capital costs, he proceeds to canvass the territory in order to estimate the probable gross receipts. This is not a simple matter. An actual count is made of the business and social activities of the various towns and cities and from these the engineer judges whether the people are progressive, and whether their activities are such as will likely lead them to use the projected road. So impor-

[11] The canvassing method as applied to the analysis of capital costs consists in obtaining from contractors, builders, equipment houses, and others, actual estimates of the cost of building and equipping a plant designed for the particular enterprise to be promoted. A theoretical example of the statistical method of calculating the consumption, that is, computing gross income, will be found in Harry Tipper, "The New Business," pages 154 *et seq.*

tant is it that this be done carefully and accurately that we shall appropriate space to show how, in the case under consideration, one of the cities is described:

Marion, the county seat of Marion County, is a thriving railroad and manufacturing city located forty-four miles north of Columbus

The Columbus, Delaware and Marion Railway is in operation south to Columbus, and a line is now under construction north to Bucyrus. This line gives excellent passenger and freight service, having hourly schedule from six a m to nine p m to Columbus, and ten and eleven p m to Stratford Cars arrive from Stratford at six, seven, and eight a m , and from nine a m to eleven p m from Columbus The running time from Marion to Columbus is two hours and twenty-five minutes, and from Marion to Delaware one hour, making connections at Prospect for Richwood and at Delaware for Magnetic Springs The fare from Marion to Columbus is seventy-five cents, round trip one dollar forty-five cents, from Marion to Delaware forty cents, round trip seventy-five cents

Four railroads pass through Marion—The Big Four, Erie, The Columbus, Hocking Valley and Toledo, and the Columbus and Sandusky branch of the Pennsylvania

The Erie Railroad freight tonnage at Marion for last year was eight hundred fifty thousand tons, the passenger earnings at Marion Station were eighty-five thousand dollars This covers outgoing business in both directions

The principal manufactures are steam shovels, contractors' tools, and harvesting machinery The limestone quarries have an enormous output of crushed rock, building stone, and lime

The growth of Marion in recent years has been phenomenal—the population in 1890 was 8,327, in 1900 11,862, and at present it is estimated at 17,000

The value of property, according to tax duplicates, is six million seven hundred thousand dollars, actual real estate values eighteen million two hundred fifty thousand dollars

The industries of the city are carried on by about fifty manufacturing companies giving employment to more than five thousand persons with an annual payroll in excess of three million dollars

The numerous enterprises of the city are listed as follows

Municipal

18 Miles of Paved Streets
Water Works
Sewer System
Garbage Disposal Plant
4 Parks
3 Fire Departments
1 Patrol Station

Steam Railroads·

The Big Four
The Erie

Columbus, Hocking Valley Toledo
Columbus and Sandusky

Electric Railroads

Columbus, Delaware and Marion Railway
Marion Railway, Light and Power Plant

Manufacturing:

Marion Steam Shovel Company
Huber Manufacturing Company
2 Brick Manufacturing Companies
2 Planing Mills
2 Ice Companies
3 Stone Quarries
1 Brewery
1 Silk Manufacturing Company
3 Cigar Manufacturing Companies
1 Monumental Works
3 Wagon Manufacturing Companies
8 Blacksmiths

Financial

5 Banks
3 Building and Loan Associations

Commercial·

1 Bottling Works
5 Piano Stores
9 Hardware Stores
10 Hotels
10 Liveries
6 Jewelers
44 Saloon and Liquor Stores
53 Groceries
11 Dry Goods Stores
11 Druggists
3 Express Companies
2 Telegraph Companies
2 Telephone Companies
5 Dairies
8 Clothiers
9 Wood and Coal Yards
2 Furniture Stores
5 Feed Stores
19 Meat Markets
4 Restaurants
2 Wholesale Grocers
20 Barber Shops
2 Daily Newspapers
2 Semi-weekly Newspapers

4 Weekly Newspapers
22 Shoe Dealers
8 Confectioners
8 Millinery Stores
5 Cigar Stores
2 Florists
2 Laundries
3 Undertakers

Educational

10 Public Schools
1 Public Library

Amusements

Opera House
Fair Grounds
1 Skating Rink

Charitable and Religious

2 Hospitals
Young Men's Christian Association
23 Churches
40 Secret Societies[12]

A survey is then made of the population. The report says:

> In estimating passenger income, the total population has been taken four miles from located line for direct traffic For tributary passenger income, an estimate has been made of the population along steam and electric roads out of Lima, Kenton, and Marion to the principal city or village at a distance not exceeding fifteen miles from the Lima-Eastern Railway

In estimating the population in the eight-mile strip (four miles on either side of the located line) the population for each township involved is listed, the percentage of the township that lies within the eight-mile strip is approximated, and the same percentage of the population of that township is tabulated as being within the directly tributary strip of territory. Thus the population of one township, Liberty, was 1,410, the percentage of the township lying within the directly tributary territory was said to be 40 per cent, and the directly tributary population, therefore, was listed at 564. Where villages or cities were involved, the figures for the latest two decennial censuses were given and from these the estimated population was derived, on the principle that the *rate* of

[12] C W Gerstenberg, "Materials of Corporation Finance," pages 481–3

growth in population during the ten years between the two censuses had continued since the latest census. The population that will be directly served by the projected road is estimated in this way to be 76,740. The tributary (that is, outlying) population is figured in the same way to be 41,735.[13]

The report then examines the nature of special activities, such as mail, package freight and express, dairy products, and general freight, to see if they offer possibilities for income.

The summary of estimated total revenue is as follows:

ESTIMATED ANNUAL REVENUE

1. Passenger Traffic		
(a) Directly on line, 76,740 at $2 25	$172 665 00	
(b) Tributary to line, 41,735 at $0 22½ (1–10 of above rate)	9,390 00	
(c) Transfer of passengers from distant points on roads, from and between steam and electric railroads, in Lima, Kenton, and Marion	2,500 00	
		$184,555 00
2 United States Mail .		7,500 00
3. Package Freight and Express		9,300 00
4 Dairy Products.		
(a) Milk	$5,760 00	
(b) Butter, eggs, etc	1,000 00	
		6,760 00
5 Freight:		
(a) Coal . . .	$1,500 00	
(b) Farm products	6,000 00	
(c) Miscellaneous	200 00	
		7,700 00
Total estimated revenue		$215,815 00

Importance of correct estimates of probable income.—The importance of estimating correctly the probable income of a

[13] This method is considered by L E Fischer in his "Economics of Interurban Railways" to lead to erroneous results Fischer contends that the population of the principal, or, as he calls it, the primary terminus, should be omitted, and that it is unnecessary to pay any attention to the strictly rural population between towns, since if the towns are large and close together the rural population is likely to be correspondingly dense, while if the towns are small and scattered the rural population is likely to be sparse Of course, in estimating what the *per capita* income will be, Fischer would use a much larger multiplier to show the *per capita* contribution than does the engineer making the report under consideration While Fischer's method is much simpler and perhaps equally accurate (his contention that the population of the primary terminus should be omitted seems incontestable where one of the termini is conspicuously superior in size), the estimate of total income made by the engineer is about the same as that determined by Fischer's method.

projected enterprise of this kind cannot be exaggerated. Two points need consideration one is, how many people are there; and the other is, how many of these people on the average will be interested in using the service, and to what degree? The first point merely requires accuracy in collecting and manipulating simple statistical data. The other point, unfortunately, is not accurately determinable. Thus, in the above example, if the engineer had estimated that each person "directly on line" would use, on an average, $3 worth of service per year instead of $2.25, the total revenue would have been increased by $57,555—a sum equal to about 25 per cent of the total estimated revenue and equal to considerably more than all the revenue estimated to be forthcoming from all sources except that of "passenger traffic directly on line." What shall determine whether $2 25 or $3 shall be used as a multiplier? Here we must fall back on the third method of investigation—the comparative method, which we shall illustrate later (see pages 30–31). In brief, the problem may be stated somewhat like this: what is the correct multiplier in a given case where a road has been in operation, that is, what average use have people in other places made of similar interurban railway service? A proper allowance is then made for the difference in economic and social activities in the respective fields, and the multiplier for the projected road is in that way estimated. The important thing to be observed is that the estimates must not be guesswork. Every available bit of information should be brought forward and care and skill should be used in applying the results of the operations of other similar enterprises to the situation under consideration, making proper and reasonable allowances for differences in conditions.

Estimates of operating costs.—A simple statement of the financial transactions of a business for a given period may be represented as follows:

1. Operating revenues	$1,000,000 00
2 Operating expenses	600,000 00
3 Net revenue	$ 400,000 00
4 Interest on bonds, taxes, and insurance	300,000 00
5 Profits	$ 100,000 00

Item (5) and most of item (4) go to the people who put up the money to run the business. Before they can get any

return, however, wages must be paid, materials purchased, and other expenses of operation must be met The big problem we have under discussion is whether items (4) and (5) will be large enough to compensate the people who put up the money and take the risks of the business. Obviously this question cannot be answered until items (1) and (2) have been determined We have seen how a canvass is made to determine (1).

How, now, are the operating expenses to be estimated? The entire subject is handled in the report under examination in the following brief summary.

OPERATING EXPENSE

Per Car-Mile		
Maintenance	$0 025	
Power Plant Operation	0 030	
Operation of Cars	0 055	
Miscellaneous	0 020	
Per Car-Mile	$0 130	
Car-Miles:		
Passenger Service.	743,200	
Express, Freight, Work Trains, etc	137,600	
Total Car-Miles	880,800	
880,800 Car-Miles at $0 13		$114,505 00
Gross Income (see page 24)		215,815 00
Gross Income, less Operating Expenses		101,310 00

This method appears to be very simple. One has only to determine how many times during the day a car will cover the 55-mile trip from one end of the line to the other, multiply that number by 55 miles and the resulting number by 313 (365 days less 52 Sundays) and add to the result the car-miles estimated for the 52 Sundays. It will be noticed that the passenger cars and freight cars are treated separately in estimating the car-miles, but not in estimating the cost of each car-mile.

The cost of operating is divided into four parts: (1) the cost of upkeep or maintenance; (2) the cost of operating the power plant; (3) the cost of operating the cars (chiefly what is known as platform wages, that is, wages of motormen and conductors); and (4) miscellaneous costs, comprising chiefly the general administration expenses.

Criticism of method used for estimating operating expenses.—While this report was made for conditions as they

existed a number of years ago, it is unlikely that the estimate of operating costs was adequate even then. But aside from any quantitative mistakes, the mistakes of method are glaring enough to be condemned And while the problem involved is somewhat technical for a treatise built on as broad lines as is this book, the error must be pointed out to emphasize the fundamental principle that in making estimates care must be exercised to use facts and figures with due regard to their proper relations The maintenance costs are set down as 2½ cents a car-mile. The error here lies in the fact that some of the maintenance costs cannot be measured by the car-mile, for there is no necessary and inevitable relation between them and the car-miles. The costs referred to are the expenses of keeping the track, roadway, buildings, and other structures in repair. These costs will run whether the company produces one or one million car-miles. The repairs will be necessary only partly because cars run over the tracks. The greater part of the repairs will be necessitated by the actions of nature, such as rain, winds, freezing, and thawing. The cost of repairs due to these latter causes will have some relation not to the car-miles operated by the company, but to the number of miles of track that are exposed to the elements. It is customary, therefore, to divide maintenance costs of railways into two parts—maintenance of equipment, which may properly be measured by the number of car-miles, and maintenance of road and structures, which is usually measured by the miles of road.

The same question may be asked here as was asked in connection with the multipliers in estimating the revenue. How do we know whether to take as the unit cost for "operation of cars" 5½ cents or 25½ cents? And the same answer must be given here as was given in the case of revenue. We must arrive at these unit costs from an examination of similar enterprises in operation. For some businesses, as, for example, the railroad business, these unit figures are readily ascertainable from published reports. But if we are to find out how much it will cost per ton capacity to operate a steamship, or how much per spindle capacity to run a mill, we shall have to go to people who have such information and who are willing to divulge it. This may not be as difficult as it seems, for while Jones may not be willing to tell you the exact costs in his own factory, he may give the limits of costs—high and

low—as he believes them to be in his line of business, and this information can be checked against similar opinions from Jones's competitors.[14]

Summary of economics of a projected enterprise.—We have, now, all the elements necessary to determine whether it will pay to build an interurban electric railway from Lima to Marion. For the present we may accept the figures of the engineer as correct. We are interested at the moment only in the qualitative side of the subject, in the methodology, in the *how to investigate*. Later we shall take up the third step in investigation—verification—and we shall then have occasion to come back to the engineer's figures to test them.

The whole situation may be summed up as the engineer sums it up.

Total estimated cost of construction.	$1,282,530 00
Capitalization—Bonds placed at 90[15]	1,425,000 00
Gross earnings less operating expenses	$ 101,310 00
Fixed charges—Interest at 5 per cent	71,250 00
Net income	$ 30,060 00

Plan of financing the proposition.—While this is not the place to consider methods of financing, it is interesting to note, in passing, the engineer's ideas on this subject in this particular case. According to the engineer's figures, it would appear that all the money necessary to be raised could be obtained by selling $1,425,000 of 5 per cent bonds and that after paying the interest on these bonds, amounting to $71,250, there would be left, each year, $30,060. This sum would pay dividends of 5 per cent on $601,200 of stock or dividends of 6 per cent on about $500,000. While there is nothing said in the report on the subject of cost of financing (item 6, page 17), the plan of the promoter undoubtedly would be to issue to himself from $500,000 to $600,000 of common stock for his services and expenses. This, of course, he would sell, and from the

[14] For some interesting analyses of costs, see W. L. Webb, "Economics of Railway Construction." Engineers, accountants, and market experts may be found who have such information, gathered from years of experience in the service of many enterprises. See also F. W. Doolittle, "Studies in the Cost of Interurban Transportation Service."

[15] It is doubtful if at any time in the last thirty years bonds for an interurban to be built could have been sold at 90 if they paid only 5 per cent. Probably 6 per cent bonds at 90 would represent about what could have been done for a sound project during the first decade of the twentieth century.

proceeds he would replenish his own treasury, from which would be drawn the expenses of the next promotion. The banker who placed the bonds would undoubtedly be expected to reimburse himself from the difference between the price paid by the investor and the $90 to be turned over to the company.

It may be well to state here that the road from Lima to Marion was never built. But that is another story which will engage our attention later.

CHAPTER III

PROMOTION—INVESTIGATION (CONCLUDED), CHECKING UP, ASSEMBLING, LEGAL PHASES

How to use the comparison method of investigation.—In the comparison method of determining what amount of funds will be necessary and whether those funds can be profitably employed in a projected enterprise, the important consideration is to find a number of concerns of similar size and conditions, from the statistics of which we can estimate what will be required and what will be the results. Certain errors may creep into the investigation of which the financier must be wary. First, an analysis of a single concern may be misleading. We are reminded of the promotion of such magazines as *Hamptons* and *The Columbian* a number of years ago. The promoters pointed to the wonderful success of *Munsey's*, but overlooked the hundreds of failures that did not have a Frank Munsey to guide them. Secondly, in making comparisons we must select enterprises that are somewhat similar to what our own is likely to be. For example, a single track interurban railway connecting small towns and designed to carry light traffic may cost but $30,000 a mile to build, whereas the heavier rails and larger stations of a more pretentious transportation system may entail a minimum initial expenditure of at least $100,000 a mile.[1] It would not be fair, therefore, to state that the projected road can be built for $30,000 a mile because a road has been built for that amount.

Another error is sometimes committed in using the comparison method. Instead of finding the average costs and the average operating results of a number of concerns, the investigator may erroneously use different individual concerns for comparison purposes at various stages of the calculations. Thus the argument may run: road *A* cost so much to build,

[1] The reader will appreciate this point if he will study, for example, the operating and financial statistics given for Class "A," Class "B," and Class "C" utilities by the Wisconsin Railway Commission in its annual report. See also an excellent article by F. W Doolittle on "Anatomy of the Interurban Report," in the *Electric Railway Journal*, Vol. 49, page 242.

therefore, road X will cost the same to build; road B cost so much to operate, therefore, road X will cost the same to operate. The fact may be that road A was poorly constructed, with no regard to the saving in operating costs that might have been realized by the elimination of grades or by the use of crushed stone ballast instead of sand or cinder ballast. Road B, on the other hand, may have cost a great deal to build, the original cost including provision for elimination of grades and sharp curves, the use of heavy rails, preserved ties, and first class ballast, all of which make for low operating costs.

Special cases of investigation.—Since many enterprises are similar in that they center about some central idea such as a patent or a peculiar piece of property, such as a mine or a timber tract, we may pause for a moment to consider very briefly the principles involved in one or two of these classes of enterprise.

Investigation of inventions.—The investigation of inventions may be intrusted to capable and experienced engineers and patent attorneys, but there are a few simple principles which every promoter should understand. The risks are enormous, and, in the experience of the author, who has observed a number of such instances, the inventor is likely to shilly-shally with his device, to neglect perfecting it for commercial exploitation, as soon as he finds a promoter ready to take up his patent and when, therefore, the doubt about the next day's livelihood has been removed.

Whether the invention is patented or not these questions should be asked:

1. Is the device worth while? The records of the patent office are crammed with applications for silly devices, such as a bed that will eject the lazy sleeper, a device for keeping the feet warm by conveying to them breath exhaled from the lungs, and so forth.[2]

2. Is the idea practicable? In the chemical business, for example, a laboratory reaction may be obtainable, though the production of the same result on a commercially large scale may not be attainable.

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[2] The reader is referred to "Gulliver's Travels" for other examples not more ridiculous than those occurring in actual life It must not be assumed, however, from what is said here, that patents are always valueless. Many a large industry of this country has been built up entirely on patent rights.

3. Will the device accomplish the purpose for which it is designed? We are reminded of the patent obtained on the idea of preventing fraud in the sale of cigars. The fraud consisted in putting high class bands on plebeian tobacco, and the remedy was to weave into the high grade cigar a silk thread. The claim was made by the deluded inventor that while the defrauders might substitute bands, they would not dare infringe the patent of weaving a silk thread.

4. Is the device merchantable? Safety razors, toilet preparations, and the like are hard to sell, however meritorious.

5. Have licenses or similar interests been granted in such a way as to nullify the value of the patent to the patentee or owner, and hence to the corporation to which he is planning to convey the patent?

If the patent has been obtained, these questions may be asked about it:

1. Is the patent good, in the sense that its claims have not been anticipated?

2. Are the claims broad enough? A German doctor obtained a patent on the solution of a certain East Indian gum in turpentine. Along came a chemist who patented the solution of the gum in any hydrocarbon other than turpentine.

3. How old is the patent? The life of a patent is only seventeen years.

Secret processes are difficult to investigate since the results obtained may be very expensively produced. It can hardly be expected that the inventor will divulge his process, and reliance must therefore be placed upon his integrity in his statement of costs.[3]

Investigation of timber tract.—Another example of the hazards that must be run in connection with a seemingly simple proposition is the timber tract. It would seem that practically no risks are run by the man who puts up money to place a mill on a timber tract and pays for cutting and transporting the lumber. However, there is first the question of title. Vast tracts of virgin forests in Tennessee, Kentucky, and Virginia have not been worked because it is almost impossible to get a clear title. Then there is the problem of fire risk. What is a fine stand of timber today may be a charred desert tomorrow. There is also the problem of

[3] For further information on this interesting subject, see Mois H. Avram, "Patenting and Promoting Inventions."

getting the timber out. The mountain sides may be steep and the streams practically useless Moreover, the difficulty of getting a reliable "cruise" or estimate may result in gross overestimates of value.[4]

Need for checking up the investigation.—The investigation is, as we pointed out, made by an independent expert, perhaps an engineer or a marketing analyst. In any event, the investigators are supposed to be competent and impartial However, too much reliance must not be placed on their impartiality and integrity. Frequently, an incompetent investigator is chosen because the promoter can afford to pay for his services while the services of a reputable investigator would be beyond his means. Sometimes the investigator is partial because he has an interest in the subject of the investigation. For example, promoters have frequently chosen State geologists to make a report on a proposed cement plant. The State geologist is interested in attracting industry to the State; that in effect explains "the reason for being" of his office. While the prestige of his office is likely to be accepted as a point in his favor, it should, in fact, be a cause for suspicion. Then, too, there is the question of fees. The promoter is anxious to have a favorable report; the investigator knows that. And because the fee is to be paid by the promoter and because the promoter, if successful in launching this enterprise with other people's money, is likely to have other projects on which he will need reports, the investigator

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[4] The following books will be found helpful in investigating propositions *General texts on methods* A Anderson, "The Financial and Industrial Investigation"; C S Duncan, "Commercial Research", J Engelbeiner, "Investigation of Business Problems", Fleming & Pearce, "Research in Industry", J G. Frederick, "Business Research and Statistics", Metropolitan Life Insurance Co , Policyholders' Service Bureau, "Better Business Through Research in New England Industry," and "Report in Applying Research to Production", New York University Bureau of Business Research, "Source Book of Research Data", W C Schluter, "How to do Research Work"; P. White, "Scientific Analysis and Organization of Markets" *On specific lines of industry, see* F W Doolittle, "Studies in the Cost of Interurban Transportation Service", L E Fischer, "Economics of Interurban Railways", Harvard University Bureau of Business Research, Studies in Retail Jewelry, Department Stores, Retail Shoe Stores, Wholesale Grocery Stores, Retail Grocery Stores, and Retail Drugs; Illinois University, publications of Business Research Bureau, Indiana University Business Research Bureau, Studies in Business; Northwestern University, "Retail Clothing Survey", J. C Pickering, "Engineering Analysis of a Mining Share", J E Pogue, "The Economics of Petroleum"; A T Shurick, "Coal Mining Costs." *See also* "Analysis of a Business Case," in L C Marshall, "Business Administration" (slate quarry in Vermont).

is likely to resolve doubts favorably to the project. Moreover, the investigator will probably meet the promoter frequently and may become infected with the latter's enthusiasm.

Checking up is all the more important because there is an insidious guarantee of accuracy in an array of figures. The number of facts included may be complete, the conclusions from those facts may be inevitable, and still there may be the simple fault of inaccurate facts

The civil and criminal liabilities placed upon issuers of securities and others for material misrepresentation of facts in registration statements and prospectuses filed under the Securities Act of 1933 make it extremely necessary for the promoter to have his investigation carefully checked before he undertakes to raise capital through public offerings.

The report evidently must be checked by somebody who represents the capitalists' interests rather than the promoter's interests. This somebody is likely to be the statistician of the financial institution to whom application is made by the promoter for the funds indicated by the report to be required for launching the project. Whoever it is that represents the sought-for capital, he must be a man of clear judgment, careful and diligent, and experienced in examining reports.

Experience teaches men to look for the glaring errors. Suppose we return for a moment to the interurban report. The cost of the 55 miles of line was estimated at \$1,282,530, or about \$23,300 per mile. The experienced statistician would have known that this was possible in the days for which the report was made. Again, the revenues were placed at \$215,815. This the statistician would probably accept as a fact to be verified later if all the other facts more readily tested proved the enterprise feasible. He indeed would be justified in doing this in this case, for the third element, operating costs, is so far from what was possible that the report should be rejected even though the revenues are accepted as correct. The car-mile cost of operation was placed at 13 cents, whereas inquiry would have revealed that 25 cents was a minimum. Using this minimum we would get these results:

Total estimated revenues (page 24)	\$215,815.00
Operating costs, 880,800 car-miles (page 26) at 25 cents	220,200.00
Operating deficit	\$ 4,385.00

No wonder the road was never built.[5]

[5] It must be remembered that all figures given here refer back to the year

Methods of checking up investigation.—There are practically three methods of checking up an investigation. One is to examine the report itself to see if it contains errors in mathematics, omissions, or false reasoning. A second method consists simply in comparing the results of one method of investigation with the results obtained by another method. A third method involves a trial of the enterprise on a small scale.

1. *Examining the report.*—Some of the errors which may be contained in a report were pointed out when the method of investigating the projected line from Lima to Marion was explained. The report referred to, for example, assumed that the rail and structures would wear out in proportion only to the number of cars that were operated and the distance they ran. The report left out entirely a consideration of the repairs necessitated by fire, flood, frost, wind, and rain. Moreover, there are certain omissions in that report in the estimate of the capital requirements. The sixteen elements that enter into the construction of the roadway (page 19) do not include roadside tools and waiting rooms. A very frequent omission is illustrated by the investigation of a hypothetical concern to sell a new automobile accessory (page 17). An allowance for contingencies was made in that case, but it is frequently omitted. It is usual in large enterprises such as an interurban railway to allow as much as from 10 to 12 per cent of the estimated capital requirements for contingencies.

2. *Checking by comparison.*—A simple method of detecting mistakes is to check a report carefully with known results. If, for example, we take the illustration of the so-called statistical method of investigating, where we found that about $40,000 was needed, and compare that sum with the investment in similar trading concerns, we can get some assurance of the accuracy or worthlessness of the details. Or perhaps a projected cement company may be shown to be a very profitable prospect since its cost of operations is reckoned to be 60 cents a barrel, whereas examination of even highly successful companies may show a minimum cost of 65 cents a barrel.

1905 Operating expenses do not vary much from place to place, hence the person checking up the report would likely know that 25 cents was more appropriate He could not check up the revenues so readily because revenues do depend on the character of the particular community to be served.

If the plant is a modest one, say of 800,000 barrels capacity, the difference in the estimated costs of operation will be reflected in an excess of profit amounting to $40,000.

In checking up by the comparison method the chief object is to find a unit for the basis of comparison. In estimating capital costs, the unit is usually the unit of capacity, such as the kilowatt capacity of an electric light plant, the mile of track of a railway, the net tons of a ship, the barrel capacity of a cement plant or an oil refinery, and the spindle capacity of a cotton mill.

In estimating probable revenues comparison is frequently made on the per capita or customer basis. For example, in comparing gas plants the first figure to get is the number of possible consumers per 100 population, then the estimated consumption of gas per consumer, and this with the price of gas per thousand cubic feet will give the probable gross earnings. In checking up these figures we simply inquire: what revenue per capita does this amount to for every person in the territory served? We know in a general way what the limits of expected revenue are, and that if the investigator's estimates of per capita revenue do not fall within those limits, something is probably wrong In checking up costs of operation the unit of comparison is usually the cost per unit of product of actual production. Thus, as we have seen, we may compare the operating costs of two cement plants on the basis of the cost per barrel of output.

3. *Checking up by trial.*—Where marketing costs are an important factor in the success of an enterprise, estimates are likely to be quite at variance with the results. In other words, the margin of error is likely to be large. The best way to reduce a possible loss to the minimum is to check up estimates by making trials. For example, it is planned to form a company to market a new trade-marked brand of coffee. Instead of carrying out a campaign throughout the entire country, a test may be made in one community, the factor of error in calculating, which is revealed by an actual attempt to market the new brand in that community, may be assumed for the country as a whole.

Second step in promotion.—After a discovery has been made and it has been decided to go ahead, the elements of the business must be brought together. The important elements from the standpoint of financial plans are: (1) the fundamental

idea, (2) property necessary; and (3) managerial ability. Funds, of course, are necessary, but the problem of raising them is considered under the third step in promotion, that of financing.

Assembling the idea.—The basic idea may be the discovery of some demand that is not being filled, or it may be a better way of filling a demand, or a method of reducing costs by consolidation of existing plants. How can this "idea" be contributed, and the value of it protected? An idea is not patentable, only the device for carrying out an idea can be patented. Neither can an idea be copyrighted. If, now, an "idea" without any device or property attached to it is to be brought to a promoter, only two methods of protecting it against piracy are open. One is to present it only to promoters who are known definitely not to be pirates. The other is to protect it by contract The difficulty of drawing a binding agreement is almost insuperable. How can the discoverer of such an idea, for example, as the building of a gas plant at such and such a place, prevent anybody else from building at that place? The fact is that the person who discovers the idea usually tries to protect himself, and does so to a certain extent by doing a part of the assembling himself. For example, he may obtain the special franchise to build the gas plant and in that way practically prevent others from coming in. But even in such a case the special franchise may be rendered almost useless by non-user.

The case of Harry Haskins against Thomas F. Ryan is well known and interesting.[6] Haskins conceived the idea of consolidating a number of independent lead companies and procured options on their plants. These he took, so he alleges, to Thomas F. Ryan, who professed an interest in taking up the options. Instead of taking up the options, Ryan, so the story goes, on one pretext or another delayed the consummation of the plan till the options expired, and then went about the consolidation himself. In a word, Haskins was "frozen out."

Methods of taking property.—Control of the essential property connected with an idea, whether the property be a patent or secret process, a special franchise, or the plants of the constituents of a consolidation, may be acquired in one of several ways. First, the promoter may take title in his own

[6] For a statement of facts see the complaint in C W. Gerstenberg, "Materials of Corporation Finance," pages 489–495

name. Second, title may be taken in the name of a small corporation to be expanded later or from which title may be taken by the final corporation. This apparently was the method used in the promotion of the United States Steel Corporation.[7] Another method is the trustee or escrow method, whereby the title to the property is placed in the hands of a trustee to be turned over by him to a corporation upon the performance of certain conditions, such as the payment of certain sums of money for the use of the company that is being promoted.[8] A fourth method is to procure an option, which, if not taken up, will entail only the loss of the money necessary to bind the option. To be sure, the loss may be considerable, since the persons originally owning the property may be unwilling to give binding options unless a large sum is paid. It is said that Henry Frick lost a clean million when he failed to get the necessary funds to take up his option on Carnegie's plants a year or so before the formation of the United States Steel Corporation. Finally, the property may be controlled by a contract to buy. If the contract is not put through, the promoter will have to stand ready to pay damages for breach of contract.

Valuation of properties.—When properties are to be acquired the question always arises: what shall be paid for them? This problem is somewhat different from the problem of capitalization. For example, it may be planned to promote a company that will be a consolidation of companies *A*, *B*, and *C*. The problem here is, how much are the properties of the several companies worth separately? The problem of capitalization is to determine how much they will be worth when brought together. Incidentally, it may be remarked that the difference between the aggregate of the separate values and the collective value measures somewhat accurately the value of the promoter's services.

Several methods of valuation may be mentioned. The first may be called scientific appraisal. In this method a definite and more or less scientific plan is agreed upon and the actual figures to be paid are arrived at by applying the plan to the property. Thus a patent on an automobile accessory may be valued somewhat as follows: Assume that one in every

[7] See A. Cotter, "Authentic History of the United States Steel Corporation."

[8] See, for example, C. W. Gerstenberg, "Materials of Corporation Finance," page 500.

100 automobile owners will buy a device once in two years, and will pay a profit of one dollar. The annual profits may then be capitalized at 20 per cent and the result will be the price of the patent.[9] Real estate, it may be agreed, shall be valued by taking late sales in the neighborhood and applying rules of appraisal understood by expert real estate operators and appraisers.[9a]

A second method of valuation is simply to name the appraisers and to agree to abide by their verdict.

A third method may be called negotiation. The negotiators agree upon a price, being guided perhaps, though not necessarily, by some scientific rules of valuation

Frequently, valuations are made by negotiating for part of the property and agreeing upon terms of any appraisal for the rest. Thus where a plant is to be bought, it may be stipulated that a certain sum shall be paid for the intangible property, such as trade names, patents, and so forth, but that the tangible property shall be valued through an appraisal.[10]

Valuation of goodwill.—When the goodwill of a business is to be sold, it is usually valued in the following way. The average earnings of the business over a period of time are capitalized and from that sum is subtracted the appraised value of the tangible property of the concern. The remainder will be the value of the goodwill.[11] Thus company *A* is about to sell all its assets to *X*. Its earnings for the previous five years have been, in thousands, $100, $200, $150, $250, $300. Its average annual earnings are $200,000. This may be capitalized at about 7 per cent (the rate depending on the nature and risk of the business) or at $3,000,000. If, now, an appraisal of the tangible property shows it to be worth $1,000,000, the value of the concern's goodwill will be $2,000,000, that is, the difference between the total value of $3,000,000 and the appraised value of the physical assets.[12]

[9] For more detailed methods of valuation see C W Gerstenberg, "Materials of Corporation Finance," pages 499–541

[9a] See "Mc Michael's Appraising Manual" for principles and technique of valuing various types of properties

[10] See, for example, the Deering Harvester Agreement, reprinted in C W. Gerstenberg, "Materials of Corporation Finance," page 499

[11] The diagram on page 15 with the footnote on goodwill, indicates another method of arriving at the same result

[12] See Kemper Simpson, "The Capitalization of Goodwill," P. D Leake, "Commercial Goodwill, its History, Value, and Treatment in Accounts," and J. M. Yang, "Goodwill and Other Intangibles, Their Significance and Treatment in Accounts."

Assembling managerial ability.—The importance of managerial ability is generally too well understood to be dwelt upon here. The promoter ought not to be successful in his quest for funds for a new company unless he can show that he has available the kind of managerial ability necessary to success.[13] Securing managerial ability, however, is very generally a matter of paying the right price. A greater difficulty may be experienced by the promoter in getting rid of incompetent managers. The following situation recently came to the author's attention. A concern wanted to make a definite step in expansion, amounting in effect to the promotion of a large company to take over its business and add to it large sums of new capital. The new capitalists were quite willing to pay a large salary to the inventor of the basic process to induce him to use his efforts to introduce improvements, but they were somewhat nonplused as to what arrangement to make with the other half-owner, who had been the general manager. It was felt that his limitations might quickly develop when he undertook the management of a much larger concern. It was finally agreed to pay him a large salary for a stipulated number of years, a part of the agreement, however, being that the capitalists might remove him from authority at any time, though in such event his salary was to continue.

Presenting the proposition.—When an idea has been discovered, that is, when it has been conceived, investigated, and checked, and when the necessary assembling has been made, the promoter has what is popularly called a "proposition." His next step is the financing of the proposition. However this is done, the previous work will have to be organized for presentation to the prospective capitalists. A careful pro-

[13] The management element was lost sight of to some extent during the height of the recent merger movement, that is, from 1926 to 1929, as business units kept growing in size. Not only did promoters begin to conceive ideas for giant corporations without considering who would run the vast enterprises, but investors also began to be carried away by the magnitude of the enterprises proposed and to take management for granted. An extreme case may be cited illustrating this tendency. Certain promoters proposed the formation of a company to build a line about 175 miles long from Texas Panhandle to Kansas City, where it was proposed to sell gas in competition with other similar services which had been operating for many years under a pipe line system from the same field. The promotion became known as the Kansas City Texas Pipeline Co. The promoters had prepared a financial plan for the corporation, but had made no arrangement for management of the enterprise. The scheme failed; no one with any real management experience would undertake to operate an enterprise such as the one proposed.

moter will keep a file of all papers and correspondence connected with the discovery and assembling. These will be available to the capitalists in checking up the accuracy of statements made by the promoter in his formal presentation. This latter document should be a well-organized, clear, concise statement of the proposition, supported by copies of engineers' and accountants' reports, lawyers' opinions, copies of legal documents, copies of government reports, pamphlets, and material relied upon to show the value of the plan. The document of formal presentation will be much more voluminous than a prospectus designed to sell securities of the company to the general public. It will be neatly arranged and will convey in its physical appearance some degree of the care exercised in making the discovery and accomplishing the assembling.

Financing.—The third step in promotion is financing By financing is meant the actual acquiring of funds with which to procure the necessary property, tangible and intangible, and with which to perfect the organization, start operations, and keep them going until the business is on a self-supporting basis. We cannot properly study this subject till we have considered the instruments with which such funds can be raised, and the legal organization which the financing entails.[14] For the present, then, we shall omit the consideration of financing and turn our attention to organization, ownership, and credit instruments, and to an analysis of possible financial plans In short, our next problem is, what can the promoters offer the owners of the funds in exchange for them—shares in a partnership, participations in a syndicate, stocks, bonds, what? But first let us consider a few indispensable questions of the law of promotions.

Some legal considerations in promotion.—While this is not a book on law, there are some legal questions connected with promotion that every promoter will care to know. They affect to such an extent the work that the promoter is doing or can do that expertness in promotion cannot be achieved without knowing something about them.

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[14] However, it should be said here that the cost of financing the promotion up to the point where the final proposition is presented to the capitalists should be borne by the promoter himself If the project fails to mature into a promoted concern, the promoter will be out of pocket; if the financing is successful, he will reimburse himself from the contributions of the participants to whom interests in the business are sold.

Who is a promoter?—Anybody who undertakes to organize or to assist in the organization of a corporation or other association is a promoter.[15] A promoter can hardly be said to be an agent because the principal for whom he is working is not in existence.

It will be noticed that any person who assists in the promotion of a company is a promoter. This statement is literally true, for if a person knowingly engages in work connected with the promotion of a company, he is to act fairly and not to conspire with the acknowledged promoter to make unreasonable profits out of the new enterprise.

Promoters cannot make secret profits.—A promoter occupies a fiduciary relationship toward the corporation he is promoting, and he is therefore required, in his dealings with the corporation while he is a promoter, to protect the interests of the company and its future stockholders. He may not take advantage of his trust position to make a secret profit for himself.

The Federal Securities Acts contain no specific provision making promoters liable to the corporation for secret profits, but some measure of control over promoters' profits is possible through the right of the Securities and Exchange Commission to compel disclosure within reasonable limits.[16]

When does a promoter begin to promote?—It is therefore essential to know when a promoter begins to promote. The following illustration shows the importance of the question. A man owns a piece of property and has held it for a long time. He promotes a corporation to take over the property. At what price must he yield it to the company? The property

[15] This definition is recognized in court decisions dealing with registration of securities under the Securities Act of 1933, forms for which call for certain disclosures with regard to promoters. The registration form, however, may expand the definition of a promoter. One such official form, for example, includes in the definition of a promoter any person who in consideration of service has received or is to receive 10 per cent or more of any class of securities of the company.

[16] The Commission is empowered to issue a stop order if the registration statement either includes any untrue statement of a material fact or *omits any material fact required to be stated therein or necessary to make the statements therein not misleading*. This power has enabled the Commission to issue stop orders in cases where the valuation of property acquired from promoters, as shown in the registration statement, has appeared to be excessive. A stop order has the following effects: (1) it suspends the effectiveness of the registration statement, and the issuer of the securities may not use the mails and facilities of interstate commerce in the sale of the securities; (2) it serves as a warning to the investing public that the Commission has found that the statement is untrue and misleading, and therefore unreliable. See Prentice-Hall Securities Regulation Service and 49 *Harvard Law Review* 789.

may have appreciated year by year and he is entitled to no profit through his holding that may accrue during the time of promotion. On the other hand, he is not bound to turn it over to the company at the very small price he may have paid for it when he first bought it. The answer is that he must give it to the company at what it was worth at the time he became the promoter, and this time is fixed as the moment he conceived the idea of promotion. Since it is hard to read men's minds, a more practical rule is that the promoter begins to promote when he first does something in connection with that operation.

When does a promoter cease to promote?—A person who has ceased to act as a promoter may deal with the company "at arm's length" and may make a profit from his transactions as may any other third person. It becomes important, therefore, to inquire, when does a promoter cease to promote? The test of the completion of promotion is the election of a permanent board of directors by the real stockholders in interest. Such directors are charged with the management of the company and are not permitted to delegate their authority or judgment to others, except to the officers as provided in the by-laws of the company. Hence, it must be evident that the promoter may say to the permanent directors, "If you care to buy this property, I'll sell it at such a price," and the bargain, in the absence of any misrepresentations, will be binding on the company.

The question is often raised as to whether a promoter is under any obligation to continue his promotion. Neither the company that is being promoted, nor individuals who have subscribed to the stock, can claim that such an obligation rests on the promoter unless the latter has made an express or implied contract that binds him to continue the promotion. For example, you may give a promoter one thousand dollars for stock of a corporation to be organized and promoted, on condition that the promoter will raise a certain number of thousands of dollars from other people. Under these circumstances he will be compelled to promote the company until he raises the stipulated sum.

Other circumstances under which promoters may make a profit.—Other circumstances under which the promoter may make his dealings with the company absolutely binding are the following: (1) He may make a full disclosure of all material facts to each original subscriber of shares in the corporation; (2) he may procure a ratification of a contract after disclosing

its circumstances, by vote of the stockholders of the completely established corporation, (3) he may be himself the real subscriber of all the shares of the capital stock contemplated as a part of the promotion scheme.

Adoption of promoter's contracts.—We have seen in connection with the assembling of a proposition that various contracts are made for acquisition of property and for engaging the services of employees of one grade or another Sometimes these contracts are made with trustees for the corporation. At other times they are made in the name of the corporation. In any event, they are not binding on the corporation until the corporation knows all about them and adopts them The adoption of the contract need not be by express action of the corporation, but may be inferred from the acts of the corporation or its agents Similarly, there need be no express acceptance of the contracts by the corporation. The corporation cannot be said to adopt any contract the terms of which it does not know fully. It is improper, therefore, for a promoter to turn property over to a corporation, stating that he is to make a profit on it or that the corporation's directors can find out how much the profit will be by consulting certain deeds.

Remedies for fraudulent acts of promoter.—Where the promoter did not make a full, frank, and fair statement of the profits he was making out of a transaction with the corporation during the period of promotion, the directors, when they learn of the secret profits, may either rescind the contract, return the property and receive back the stock or cash paid for the property, or they may sue the promoter for the secret profits, or they may sue for any other damages. For example, a promoter cannot permit people with whom he deals to make unreasonable profits out of the corporation If the promoter did permit such unreasonable profits to be made, the corporation would not be bound to recover those profits from the third person, but could sue the promoter for the damages, which would be measured by the unreasonable amount of profit paid to the third person.

Subscription contracts.—A promoter should know the law on the subject of subscriptions in the State in which his corporation is to be organized. A subscription agreement made as an individual transaction between a subscriber and a proposed corporation cannot take effect as a contract because one of the parties is not in existence. To make the subscription agreement binding as a contract, it may be written as an

agreement between the subscribers who contract with each other and with the proposed corporation or its promoters Thus, it is usual to insert in the contract a clause stating that the consideration for the subscription is the subscriptions of other subscribers. Another way to make a presently binding subscription contract is to write it as an agreement between the subscribers and an agent or trustee for the proposed corporation. A form of subscription to a corporation about to be organized and a simple form of subscription for a corporation already in existence follow.[17]

SUBSCRIPTION AGREEMENT

(Corporation About to Be Organized)

I hereby subscribe to ( ) shares of the capital stock of , a corporation to be formed under the laws of the State of , with a total authorized capital stock of ( ) shares, having a par value of ($) Dollars each, for the purpose of ; and I hereby agree to pay ($) Dollars for said subscription to Bank, Trustee, or its assigns, upon demand by the said Trustee before incorporation and by the corporation after incorporation, in payments of (%) per cent each, at any time after ( ) shares of the capital stock of said proposed corporations, including the subscription herein made, have been subscribed for, the second payment, however, not to be called for until at least . days after demand has been made for the first payment

Dated , 19

SUBSCRIPTION AGREEMENT

(Corporation Already in Existence)

Each of the undersigned in consideration of the subscriptions of the other subscribers hereby subscribes for the number of shares of stock of the of the class set opposite his signature, and hereby agrees to pay the par value thereof in cash, to the treasurer of the corporation as follows ten per cent on the signing of this subscription, and the remaining ninety per cent at such time or times as the board of directors may require by resolution and notice, in writing, to the subscribers, but such requirements shall be uniform and prorated among all the subscribers according to the amounts of their several subscriptions.

Signature	Number of Shares	Class of Stock	Amount of Subscription	Date

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[17] For other forms, see "Prentice-Hall Encyclopedia of Corporate Forms," Vol. 1, Nos. 51–74.

Compensation of promoters.—It has been shown that a promoter cannot make any profits out of a corporation except those that arise out of the contracts made with the promoter after the corporation is organized and has its own directors—dummy directors appointed by the promoter will not do—or where the profits made are known to the permanent directors when they adopt the transactions previously made by the promoter. It is true, however, that a promoter, like any other person who acts in a trust position, is entitled to reasonable compensation for his services. It is altogether permissible, therefore, for a company to give stock to the promoter in payment for his services as long as the amount of such stock is reasonable.[18]

The Securities and Exchange Commission has insisted upon full and fair disclosure of promoters' profits in registration statements and has issued several stop orders[19] where registration statements have failed to reveal the names of promoters and payments made to them. It is significant that such stop orders have occurred principally in the case of registration statements filed by newly organized mining companies, a type of enterprise that is highly speculative and in which promoters' profits are easily concealed in the transfer of properties to the new company at excessive values.

Usual arrangement for compensation of promoters.—In the vast number of organizations and reorganizations that have been promoted in the past two decades, the general procedure has been to sell non-par preferred stock to the public to pay for whatever assets are purchased by the new company, and to turn over to the promoters, organizers, reorganizers, and bankers as compensation for their services in promoting the company, blocks of the common stock without par value. Sometimes a small portion of the common stock is given as a bonus to the purchasers of the preferred shares. If the company is successful, the profits of the promoters will be large; if the company fails, the capital contributed by the preferred shareholders will be at stake. By giving to those who contribute the capital, shares of preferred stock that have a prior claim to assets, and by issuing to the promoters common stock without par value, rather than with par

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[18] For a study of promoters' profits, see W. Z. Ripley, "Trusts, Pools and Corporations," Chapter XIII, The Asphalt Combination. W. M. Fletcher's "Cyclopedia of the Law of Private Corporations" is a standard work on corporation law, in several volumes, with periodic supplements.

[19] See footnote 16.

value, the modern corporation avoids legal difficulties that in past years troubled organizers of corporations. To discuss what the difficulties were in the past and how they are overcome by the present practice would involve us in questions reserved for later chapters. Suffice it to say here that the device of non-par value stock avoids the necessity of fraudulently overvaluing property or pretending that value has been received for the stock issued,[20] the plan of classifying non-par shares and giving those who have paid for their shares a prior claim on assets prevents impairment of the capital contributed by the preferred shareholders through claims of those who have received their shares as compensation for promotion services.[21] While technically the arrangement under which promoters receive their compensation in stock may meet all legal requirements, there may be instances where the arrangement would be unfair to incoming shareholders. In such cases, unless the persons concerned have consented to the arrangement, they may complain of the transaction and obtain the aid of the courts in dealing with the offenders.

Payment of promoters with options to purchase stock.—Another device for paying promoters for their services that has been used extensively in recent promotions is the option to purchase stock. The corporation authorizes the issuance to the organizers of an option or right to purchase shares of stock at a stated price, generally within a fixed future period. Thus, without immediate expenditure, the option holders acquire an opportunity to make a substantial profit in the future in the event that the corporation is successful. The option, of course, will not be exercised unless the price of the stock exceeds the price fixed in the instrument. As in the case of stock given as compensation for services rendered by promoters, the giving of an option is a valid means of compensating promoters, provided the transaction is fair and not unreasonable and oppressive.[22]

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[20] See page 308.

[21] The student who is interested in the subject of equitable control of promoters' profits should read "Bankers' and Promoters' Stock Profits," by A A Berle, in the *Harvard Law Review*, April, 1929

[22] What is reasonable is always a question for a court of equity to decide. The facts and decision in a single case will serve to illustrate what may be expected from the courts. While a certain corporation was still in an embryo state, its directors entered into a contract whereby the promoter was granted the power to sell the company's non-voting stock on commission and was given the sole right to purchase 5,000 shares of its voting stock, with a five year option to take the 15,000 remaining shares at $10 a share. The 5,000

Disclosure of options granted is necessary in the case of securities which must be registered under the Securities Act of 1933. Both the registration statement and the required prospectus call for a statement of the securities covered by options outstanding or to be created in connection with the issue covered by the registration. The statement must show the price and other terms on which the options are granted, as well as other information, including the names and addresses of all persons to be allotted more than 10 per cent of any set of options.

Prior to the enactment of the Securities Act of 1933, disclosure of the issuance of options was within the discretion of the issuing corporation. In some instances, the option that had been given was disclosed in the certificate of incorporation or in the circular issued upon the sale of stock in the corporation, or in both places; in other cases the option was not disclosed This situation still exists where the public issue of securities is exempt from registration because it does not exceed $100,000, or because the channels of interstate commerce are not being used in its distribution.

Right of officers to compensation for promotion of subsidiary companies.—Officers of a corporation will sometimes promote a subsidiary company that is neither entirely a subsidiary nor entirely independent of the parent company, and will take in compensation for their services as promoters stock of the newly formed company. In many cases where such corporations are formed, the new company becomes engaged in a business collateral to the activities of the principal corporation, and the capital is obtained from stockholders in the existing corporation. In other words, the officers of the existing corporation take advantage of the strength of the corporation and of the opportunity to obtain capital from its stockholders to promote the new company. There may be some question in such cases as to the right of the officers to profit in this way by their position as officers in the principal corporation. The rule has long been established

shares were to be purchased out of commissions to be earned by him in the sale of the non-voting stock. These shares were thus acquired by the promoter, with the result that he was in absolute control of the corporation, with full power of disposition over its assets, without having invested any money whatever except such as he received by reason of his connections with the corporation The court decided that the transaction was not reasonable and appointed a receiver upon the application of a stockholder Hechler v. Emery, (1928) 131 Misc 393, 226 N Y Supp. 599

that where a corporation has an opportunity for a profitable transaction, it is the duty of the officers to exploit such an opportunity for the benefit of the corporation, and if they profit directly or indirectly where the corporation should have profited, they may be required to account for the profits thus obtained [23]

The Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935 contain provisions which make it difficult for officers of subject corporations to profit by their positions in the manner described above [24] A full and complete disclosure of the officers' compensation as promoters would be required in the registration of the securities of the new company under the Securities Act of 1933 Such disclosure, the officers may realize, would discourage the purchase of the securities by the existing stockholders

If the parent company were a public utility holding company, subject to the Public Utility Holding Company Act of 1935, and the subsidiary were a public utility, the acquisition of the subsidiary's stock by the officers could not be effected without the approval of the Securities and Exchange Commission [25] Even if the subsidiary were not a public utility, the transaction could not be effected without a disclosure of the issuance of stock to the officers of the parent company for services. Such disclosure would appear in the forms required to be filed under the Utility Act with the Securities and Exchange Commission in connection with the issuance of the subsidiary company's stock. Furthermore, the Commission has interpreted the Act so as to impose standards which proceed far beyond the principle of disclosure Thus, one of the objectives of the Commission is to eliminate profits arising from failure to recognize fiduciary responsibilities.[26]

[23] See "Promoters' Stock in Subsidiary Corporations," by A A Berle, 29 *Columbia Law Review* 35 See also "High Finance in the Twenties," 37 *Columbia Law Review* 785, for example of tremendous promoters' profits made possible through issuance of perpetual option warrants in the formation of the United Corporation in 1929

[24] Both the Securities Exchange Act of 1934 and the Public Utility Holding Company Act of 1935 contain a provision which permits recovery of any profits realized by officers and directors of companies subject to the Acts from transactions in securities of such companies within a period of six months, unless the securities were acquired in good faith in connection with a debt previously contracted.

[25] See page 697

[26] See "Regulation of Corporate Finance and Management under the Public Utility Holding Company Act of 1935," 52 *Harvard Law Review* 216

Chapter IV

FORMS OF ORGANIZATION—INDIVIDUAL PROPRIETORSHIP, PARTNERSHIP, JOINT ADVENTURE, AND JOINT STOCK COMPANY

Importance of correct selection of legal form of organization.—No step in business building and management is more important than that of selecting the legal form of organization, for upon the form of organization depend not only the division of the profits of the business, but the risk run by all those interested, the amount of money that can be raised, the placing of control, and many other incidental questions. Before we can go into these interesting and important matters, we had better describe briefly the forms of organization that are used in English-speaking countries.

Legal forms of organization.—The common forms of organization are: (1) the individual proprietorship; (2) the general partnership; (3) the limited partnership; (4) the joint adventure; (5) the joint stock company; (6) the limited partnership association; (7) the Massachusetts or business trust; and (8) the corporation.

Prevalence of different forms of organization.—The desirability of the different forms of organization for large concerns and small concerns is indicated by the prevalence of the several forms in American business. It will be noted from the table on page 51 that both the individual form and the miscellaneous forms of organization have decreased relatively, while corporations have increased. The parts of the table showing number of wage-earners, value of the product, and value added by manufacture, indicate that corporations have grown in number most notably in those industries in which the units are large.

The individual proprietorship.—The individual proprietorship needs little explanation. When a man goes into business all by himself, he owns all and risks all. If he cares to, he can incorporate his business and still own it, giving to others nominal interests and making them co-directors, but requiring

TABLE No. 1

STATISTICS OF FORMS OF ORGANIZATION[1]

Character of Ownership	1929		1919		1914		1909		1904	
Number of Establishments and Per Cent Distribution										
	Number	%	*Number*	%	*Number*	%	*Number*	%	*Number*	%
Individuals			138,112	47.0	142,436	51.6	140,605	52.4	113,946	52.7
Corporations	101,816	48.2	91,517	31.5	78,152	28.3	69,501	25.9	51,097	23.6
All others	109,144	51.7	60,476	20.8	55,203	20.0	58,385	21.7	51,137	23.7
Average Wage Earners per Establishment										
Individuals			4.0		5.0		6.0		7.0	
Corporations	78.0		86.0		72.0		72.0		76.0	
All others	8.1		10.0		12.0		18.0		21.0	
Value of Product — Average per Establishment and Per Cent Distribution										
	Dollars	%	*Dollars*	%	*Dollars*	%	*Dollars*	%	*Dollars*	%
Individuals			25,605	5.7	13,518	7.0	14,523	9.9	14,944	11.5
Corporations	637,437	92.1	598,188	87.7	258,255	83.2	235,121	79.0	213,399	73.7
All others	50,705	7.8	68,413	6.6	38,726	8.8	89,203	11.1	42,768	14.8
Value Added by Manufacture—Per Cent Distribution										
	Per cent		*Per cent*		*Per cent*		*Per cent*		*Per cent*	
Individuals			6.2		9.1		11.4		13.1	
Corporations	91.4		87.1		81.9		77.2		71.9	
All others	8.5		6.7		8.9		11.3		15.0	

[1] From Abstract of the Census of Manufactures for 1919, published in 1923. At the census for 1929, unincorporated concerns were not required to report their ownership as "individual," "partnership," etc. According to official information dated Oct. 31, 1938, no statistics in regard to type of organization have been compiled in any Census of Manufactures since that for 1929. Testimony from the records of the Bureau of Foreign and Domestic Commerce, offered to the Temporary National Economic Committee in December, 1938, contains the estimate that between 60 per cent and 65 per cent of national activity was in corporate hands (the latter percentage being a better estimate if municipal and other business operations are classified as corporate).

The relative importance of large corporations in American economic life is indicated in the following summary. In 1930, 227,340 corporations with total assets of $50,000 or less, and comprising 54.6 per cent of the total number of corporations which filed income and excess profits tax returns with balance sheets, owned assets amounting to only 1.3 per cent of the total assets of all corporations. On the other hand, 390 corporations with total assets of $100,000,000 or over, and comprising less than 1/10 of 1 per cent of all corporations, owned 44.3 per cent of all the corporate assets ("Statistics of Income for 1936," U.S. Bureau of Internal Revenue.) See also Berle and Means, "The Modern Corporation and Private Property," 1932; Twentieth Century Fund, Inc., "Big Business: Its Growth and Its Place," 1937; National Industrial Conference Board, "American Enterprises—Number and Size," 1938; "Hearings Before a Subcommittee of the Committee on Judiciary," U.S. Senate, 75th Congress, 3d Session (1938) on S.10 and S.3072 (Federal Licensing of Corporations); *Dun's Review*, March, 1939, "How Big Is Big Business—An Analysis of Conflicting Testimony"; *Dun's Review*, May, 1939, "Is Big Business Getting Bigger?"

that they shall consent to a practical surrender of all authority to him through the simple device of electing him president and writing into the by-laws of the corporation a provision that the president shall be the general manager. Or the proprietor may turn his business into a Massachusetts trust. But at this place we merely wish to point out that a man can organize his business in several ways and still exercise control If he selects the corporate form or the trust form, he can avoid subjecting to the risks of his business venture property not definitely committed to the business

It must be clear, therefore, that the individual proprietorship is distinctly a form of business organization. The fact that a person who does nothing about the legal form of organization will be deemed by the law to have chosen this form, does not render the sole proprietorship any the less a method of organizing. Here the income above the debts payable to creditors, the exclusive right to control the operations, and the entire risk are centered in the proprietor.

The general partnership.—If several persons engage jointly in business without making any special provision for the legal form of their organization, they will be held to constitute a general partnership. To be sure, they may, and usually do, make a contract orally or in writing setting up the partnership relation. But even if they neglect this step, the law will imply a partnership [2]

General agency in partnerships. In the partnership, each partner is a general agent for the business This simply means that each partner may make contracts that will bind the partnership, or the firm as it is sometimes called.

An example will make this clear. Jones, of the firm of Jones & Smith, buys a mahogany desk for the bookkeeper. Smith goes to another dealer and buys an oak desk. Both dealers can hold the firm to their contracts of purchase. Suppose Smith had agreed with Jones that he would not buy anything for the firm. The dealer who sold the oak desk may still insist upon the sale, unless, as in all agencies, he, the third party, knew that the power of the agent was limited.

The reader will realize that one should not enter into a partnership with a person whose judgment in making con-

[2] For an example of a partnership agreement, see C. W Gerstenberg "Materials of Corporation Finance," pages 1-3 For other forms relating to partnership, see S Gordon, "Standard Annotated Forms of Agreement," Chapter XVII

tracts is not good, or with one who, if he agrees to refrain from making contracts, will forget or disregard his promise.

Delectus personae.—This formidable expression is merely the legal jargon for the right to select a partner which is implied in every partnership agreement. Because a partner is an agent, and because in law an agent cannot delegate his authority, it follows that a partner cannot transfer his interest to another person without his partner's consent. So, if a partner dies, goes insane, becomes bankrupt, or withdraws for any cause whatsoever, his executor, guardian, or trustee in bankruptcy does not take his place In each of these cases the newcomer—the executor, guardian, or trustee—has the right only to make the remaining partners account for and pay over the cash value of the interest of the partner whom the newcomer represents

Liability of partners.—The members of a general partnership are jointly and severally liable for the debts of the firm. By this we mean that the creditors may collect from the partners' several private estates if their joint or partnership property is insufficient to defray the debts. In the absence of a specific contract, partners share profits and losses equally, though it is customary where partners contribute different amounts of capital to provide in the partnership contract that the profits and losses shall be distributed in the same proportion.

An illustration will serve to make clear a number of rules relating to partners' liabilities. *A*, *B*, and *C* are members of a partnership which has assets of $10,000 and debts respectively to *X*, *Y*, and *Z* of $10,000, $20,000, and $30,000. To prevent any one creditor from seizing the $10,000 of assets, a receiver is appointed by a court of equity to wind up the partnership affairs. *A* owes $20,000 to his private creditors, and has assets worth $10,000. *B* owes $10,000 and has $20,000. *C* owes $20,000 and has $20,000. There is a rule of law, called "marshalling of assets," which provides that in a case like this the partnership creditors have first right to the partnership assets and private creditors have first right to the partners' individual properties. Hence, the $10,000 partnership assets will go to *X*, *Y*, and *Z*; *A*'s $10,000 will go to his creditors; *B*'s creditors will take $10,000 of his property, and the rest will go to *X*, *Y*, and *Z* under the rule of the joint and several liability of partners. *C*'s creditors will take all

his property. Since *B* will have paid $10,000 out of his own pocket to help satisfy the partnership creditors, he will have a "right of contribution" against *A* and *C*, that is, if their obligations are not wiped out by bankruptcy, they will each owe him $3,333.33.

This division of losses would be followed as to *X*, *Y*, and *Z*, even if the partners had agreed that *B* should in no event be liable to outside creditors *X*, *Y*, and *Z* would collect from *B*, but then *B* would have a claim of $5,000 against each of *A* and *B*. The point is that one person can not agree with another that a third person's rights shall be limited, without that third person's consent If *A*, *B*, and *C* wished to carry out their arrangement, they should have formed a limited partnership, and then *X*, *Y*, and *Z* would have had notice of *B*'s limited liability and could guard the credit they extend in view of the known restriction on *B*'s liabilities.

Division of profits and losses illustrated.—Partners, we saw, divide profits and losses equally. Suppose *A*, *B*, and *C* contributed respectively $30,000, $20,000, and $10,000 to a business in which they engaged without formal agreement. The firm is wound up and its assets of $60,000 are all that is left to pay $50,000 to creditors *X*, *Y*, and *Z*, besides $10,000 advanced as a loan by *B*, and the obligations of the partnership to the partners.

According to the uniform partnership law, debts to outside creditors must be paid off first, then debts to partners, then the capital, and finally profits, if any. Here there are losses which amount to the sum of all the debts and obligations, that is, $120,000, less $60,000 of assets. This total loss of $60,000 must be divided equally. Therefore each partner will contribute $20,000 and will take out the amount of the obligation of the partnership for capital and any debts due from the partnership. *A* therefore will put in $20,000 and take out $30,000; that is, he will take out a net of $10,000. *B* will put in $20,000 and take out $10,000 for the debt and $20,000 for capital; that is, he will take out a net of $10,000. *C* will put in $20,000 and take out $10,000; that is, he will contribute a net of $10,000. In effect, then, *C* will put in $10,000, and this with the $60,000 of partnership assets will yield $50,000 to *X*, *Y*, and *Z* and $10,000 net to each of *A* and *B*

The limited partnership.—Over one hundred years ago some commissioners were sent from New York State to

Louisiana to study the limited partnerships of the civil law, which in Louisiana takes the place of the common law prevalent in most English-speaking jurisdictions, to see if the device could be introduced into the statutes of the Empire State [3] The result was the Limited Partnership Law of New-York, which has since been copied in England, in Canada, and in most American States. Since the limited partnership is not frequently used, we shall give it only a brief description.

In the first place, it must be organized just as the law prescribes. If this is not done, a general instead of a limited partnership will result. The chief step in organization is the filing of the contract drawn according to law.[4] The limited partnership may have one or more general partners and one or more limited partners The liability of the limited or special partners is limited to the amounts they have agreed to put in. Their names must not appear in the official name of the partnership and they can have no voice in the business.

Since it is only by virtue of the statute that the liability of any of the partners may be limited, a substantial and even strict compliance with the statute is necessary to form this kind of organization. In one case where the statute required the cash contribution of special partners to be paid before the certificate was filed, and one of the special partners did not do this until after the certificate was filed, it was held that no limited partnership had been formed. The firm failed and all the partners were held personally liable as general partners. The danger that a special partner may find himself subject to unlimited liability has discouraged the use of the limited partnership statutes. To protect special partners against that liability, the statutes of some of the States have included a provision that special partners acting in good faith would not be subject to unlimited liability on account of a defect in the organization proceedings.

Another important rule to bear in mind is that, as limited partnerships are creatures of the separate State statutes, outside of the State of its formation the organization will be treated as a general partnership and even special partners will be liable to creditors. If, therefore, a limited partnership does business in another State, it should first file a certificate and

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[3] F. M Burdick, "The Law of Partnership," page 360

[4] For example, see C. W. Gerstenberg, "Materials of Corporation Finance," pp. 4–5, and S Gordon, "Standard Annotated Forms of Agreement," Form 460.

comply with the statutes of that State in order to limit the liability of its members.

The joint adventure.—The joint adventure, otherwise known as the "deal" or "syndicate," is very much like the partnership in point of law. The main differences are quite technical and relate to the way in which actions are brought in court. In general effect, of course, the main difference is that while the partnership goes on indefinitely or for a limited time, the joint adventure is organized for a specific purpose and its duration is limited to the accomplishment or definite failure of that purpose. Usually, all the business of a joint adventure is done in the name of a manager, who is responsible to the participants.[5]

The joint stock company.—The joint stock company is a form of partnership that was created to overcome some of the important disadvantages of the ordinary partnership. As in the latter, each member of the joint stock company is individually and personally liable for the entire debts of the organization But, unlike the ordinary partnership and like the corporation, the joint stock company has its capital divided into transferable shares represented by certificates. These may be sold by one person to another, enabling a partner to withdraw from the business without jeopardizing the life of the organization. These shares indicate the owner's right to participate in the control of the company- by voting—and in the profits of the business. In this respect, as well as in its form of control and management, it closely resembles the corporation.

Death, insanity, or bankruptcy of a member has no effect on the continued existence of the joint stock company. Nor has the withdrawal or transfer of membership Each member is free to sell or pledge his shares. But even if he does this, he remains personally liable for the debts incurred while he was a shareholder. He has, however, no liability for any debts contracted after he disposed of his shares, nor before he acquired them. The joint stock company further resembles a corporation, and differs from a partnership, in that it conducts business under an artificial name, may sue and be sued in that name, and may acquire and dispose of property in that name.

[5] For forms of joint adventures, see S Gordon, "Standard Annotated Forms of Agreement," Chapter XII.

Formation, organization, and management of the joint stock company.—At one time the fundamental distinction between a corporation and a joint stock company was that the former was an artificial entity that derived its existence from the State, while the latter was a natural association that derived its existence solely from the contract of the members. But now joint stock companies are not only regulated but also authorized by statute.[6] For the most part, however, they are formed under a simple contract, known as "articles of association," among the parties interested in the venture; that is, they are formed under the common law, and not under a statute

The articles of association and by-laws of the joint stock company define and regulate its organization and management in much the same manner as the certificate of incorporation and by-laws affect the corporate organization. Usually they provide that the management of the company shall be vested entirely in the hands of a small board of governors or directors,[7] periodically elected by the shareholders, as directors of a corporation are elected. Shareholders, unlike partners, are not general agents and cannot bind the association by their individual acts; the business is done for the company by officers and agents appointed and removed at the pleasure of the board of governors The board usually has also the right to declare and pay such dividends from the earnings of the company as they deem expedient

Advantages of joint stock company over corporation.—A joint stock company, of the common-law type, enjoys certain tax advantages over the corporation (1) it does not pay any organization tax; (2) it does not pay any annual franchise taxes, nor must it file with the State any certificate or annual reports such as those usually required of corporations, (3) a joint stock company may do business in any State outside of the State of its formation without any formalities, while a corporation must usually file certificates and pay franchise taxes in those States where it does business. In a Minnesota case, which would probably be considered good law in all

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[6] For a history of joint stock companies, see J S Davis, "Earlier History of American Corporations"

[7] For complete articles of association, see Articles of Pierce Fordyce Oil Association (share capital, $3,000,000), reprinted in C W Gerstenberg, "Materials of Corporation Finance," page 6

parts of the Union, the highest State court said of a joint stock company, "The defendant not being a corporation, but a partnership, has the same right to do business in this State without its permission, and free from its control and visitorial power, as any other individual or partnership "[8] In this respect it enjoys a real advantage over the corporation, which invariably must file certificates and pay taxes in every State in which it does business.

Many exceptions to these advantages, however, have been created by State statutes. For example, in New York State, where joint stock companies are organized under a statute called the "General Associations Law," annual reports are required to be filed and annual taxes must be paid in the same manner as by corporations. In several of the States the annual tax laws applicable to corporations have been made equally applicable to joint stock companies. Again, in many of the States the statutes governing the right of foreign corporations to do business in the State include joint stock companies in their definition of foreign corporations. Under the Federal tax laws, the Federal Securities Acts, and the Public Utility Holding Company Act of 1935, joint stock companies are treated in the same manner as corporations.

The offsetting disadvantage of the joint stock company as compared with the corporation is the fact that each member is individually and personally liable for the entire debts of the company. In turn, the member who may be held liable has the right of compelling the other members to contribute their shares of the loss.

Limiting the liability of members.—If the liability of members could be limited to the amount of their original capital contribution, the joint stock company would obviously be superior to the corporation. An attempt has therefore been made to do this by inserting a provision in the articles of association requiring the board of governors to stipulate against the personal liability of members in every contract made on behalf of the company. In the articles of the Pierce Fordyce Oil Association, for example, is found the following provision:

> The Board of Governors shall have no power to bind the shareholders or members personally, and in every written contract or undertaking they shall enter into relating to the business of this Association, its property or any part thereof, reference shall be made to this agreement; and the

[8] State v. United States Express Co , (1900) 81 Minn. 87, 83 N W. 465

person, firm, or corporation so contracting with the Board of Governors shall look only to the funds and property legal and equitable of this Association for the payment of any debt, damage, judgment, or decree or of any money that may become due and payable in any way by reason of the contract or undertaking, and neither the Board of Governors nor the shareholders or members present or future shall be personally liable therefor or for any debt incurred or engagement or contract made by said Board of Governors.

This provision will, of course, have no effect on parties dealing with the company unless it is called to their notice. In many jurisdictions it will have no effect unless the limitation of the members' liability is clearly and expressly stated in the contract. In at least one State, New York, there is a grave question as to whether, even then, the members' liability would be limited. In Warner v. Beers, (1840) 23 Wend. (N. Y.) 102, the court apparently held that such a stipulation in a contract would limit the liability of the members of the association. But in a more recent case, Hibbs v Brown, (1907) 190 N. Y. 167, the question involved was whether a stipulation in bonds of a joint stock company—The Adams Express Company—against the personal liability of members made them non-negotiable. It was held it did not, three—the majority—of the judges so holding on the ground that such a stipulation was against public policy and therefore void. Thus, while in practically all other States such a provision would adequately protect the shareholders, in New York it probably would not. In no State, however, is there any method by which the liability of the members may be limited in case of the commission of a tort by the association. Of course, the question of the individual member's liability will never arise as long as the association remains solvent.

The limited partnership association.—The statutes of Pennsylvania, Michigan, New Jersey, and Ohio permit the organization of limited partnership associations. These are created like corporations, and in the State of their formation, they have most of the attributes of a corporation. A certificate of association must be filed with the Secretary of State and county clerk, and an organization tax must be paid. Reports must be made and franchise taxes must be paid annually.

As in the corporation and the joint stock company, ownership is divided into shares, and the shareholders elect a board of directors or managers who conduct the business of the asso-

ciation. In Michigan the directors or managers are elected under the cumulative voting method [9]

The limited partnership association also resembles the corporation and the joint stock company in the conduct of its affairs through officers and agents appointed and removed by the board of managers. It differs from them, however, in the fact that upon a transfer of its shares by an original owner, the purchaser must be elected to membership in the association before he has any rights therein He may demand election to membership, and if this is not granted, he may compel the association to pay him the value of his shares, agreed upon or determined by appraisers appointed by a court. The transfer of shares, however, does not affect the life of the association. Another peculiar provision of the laws affecting these associations is that which requires contracts involving over five hundred dollars to be signed by two of the managers. Unless the contract is so signed, the association will be exempt from liability for it.

In the State of its organization the members of a limited partnership association are not personally liable for the association's debts But the members will be held liable as general partners unless the organization strictly complies with the statutes authorizing the organization of limited partnership associations Thus, in Pennsylvania, it was held that failure to include in the articles of association a detailed description of the property contributed as capital by the members, as required by the statute, rendered them liable as general partners [10] Outside of the State of their organization, courts have been inclined to treat these associations as general partnerships This form of organization therefore, is suited only to a business to be entirely conducted in the State permitting its formation. Except for the smaller initial expense of organizing a limited partnership association, it has little, if any, advantage over the corporation. Of course, if the enterprise is to do business in several States, the corporation would be more useful.

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[9] See page 109.

[10] Sheble v. Strong, (1889) 128 Pa. St. 315, 18 Atl. 39.

CHAPTER V

MASSACHUSETTS TRUSTS

The Massachusetts trust.—This organization is known under various names, such as the business trust, or business association formed under deed of trust, the voluntary association formed under deed of trust, the common law trust, and the Massachusetts trust. As a modern business device it originated in Massachusetts, where the law prohibited the organization of corporations whose purpose it was to own and deal in land This suspicion of land-holding corporations goes back in English history to the Statute of Mortmain, 1279, the purpose of which was to deprive the monasteries of their land holdings. The cause of the suspicion is the fear that, since a corporation has what is called continuous succession, it may continue to increase in size until eventually it may become more powerful than the State itself [1]

Since corporations could not be used for the purpose of assembling large sums of capital with which, for example, to build an expensive hotel, the lawyers adopted the trust principle. Basically this idea involves the separation of the ownership of property into two parts, the legal title being held in the hands of one person (the trustee) for the benefit of other persons (beneficiaries or *cestuis que trustent*—the singular form of which is *cestui que trust*[2]) who hold the equitable title. The person who sets up such a device is called the creator or settlor, and the device itself is called a trust. Simple examples of such trusts are provided when men (creators) draw wills leaving properties to trust companies (trustees) in trust for their widows for the latters' lives (the widow is then called a life tenant), the estates upon the deaths of the widows to go outright to the testators' children (called remaindermen).

[1] For a very careful legal analysis of the nature of a Massachusetts trust, see "Shareholders in Business Trusts," by Calvert Magruder, in 23 *Columbia Law Review* 421

[2] It is customary to speak of one *cestui* and of several *cestuis;* in pronouncing the latter word the final *s* is sounded.

The management of property held in trust is in the hands of the trustee He operates it if it is an operating property, he keeps it in repair, he brings legal actions to protect it, and if in its operation other persons are injured, actions are brought against him alone The *cestuis* are merely entitled to an accounting and to the income which such an accounting shows.

How the Massachusetts trust is created.—The Massachusetts trust is created through the drafting and execution of a deed of trust, which is merely a contract between the trustee and one or more persons acting as beneficiaries, who for this purpose represent not only themselves but such other persons as may thereafter, and from time to time, become interested in the trust, either by investing money in the trust, or by buying out, or in some other way receiving some other beneficiary's interest in it.[3] These interests in the trust are represented by certificates, frequently called certificates of stock, which in outward appearance simulate as far as possible the certificates of stock of a corporation. They may be listed and dealt in on the various stock exchanges. It is not uncommon for a trust to have several classes of common and preferred shares, and it is possible to have any division of income, risk, and control among the shareholders that may seem desirable. The trustees are not unlike directors of a corporation, who manage the property for the stockholders, the *cestuis que trustent*, or certificate holders of the trust, correspond to the stockholders in a corporation. The deed or declaration of trust which is drawn up describes the business of the association and the duties, rights, and liabilities of the trustees and shareholders. The deed usually provides the trustees with authority to appoint and remove a president, vice-president, and other officers, agents, and employees who are to carry on the business of the trust. The trustees need not conduct the business in their own names, they may adopt a name for business purposes,[4] as for example, the Massachusetts Lighting Companies. In fact, it is the general practice to specify a name in the deed of trust. Moreover, they usually have a common seal not unlike the seal of a corporation. Dividends are distributed by the trustees

[3] For an example, see C. W Gerstenberg, "Materials of Corporation Finance," pages 11–20 The stockholders in that agreement, however, would be held liable as partners under rules explained later in this text

[4] Rand v. Farquar, (1917) 226 Mass. 91, 115 N.E. 286.

out of profits, as determined by the deed of trust. As a rule, the indenture gives the trustees wide discretion in the matter of declaring dividends A common provision governing dividends is that "the trustees may from time to time declare and pay dividends from the net income of the trust fund among the *cestuis que trustent;* and their decision as to the amount of dividends, and as to using therefor any portion of the surplus fund, shall be final. They may set aside from time to time such portion of the net income as shall not be required for dividends for a surplus fund. Their decision as to what is income and what is capital shall be final." This provision gives the trustees the same authority over dividends as directors of a corporation usually have.

Duration of a trust.—For reasons that we need not go into here, the laws of most States will not permit such a contract to be made for an unlimited time In New York State and many other States the time cannot be longer than twenty-one years and nine months after the death of one or two persons named at the time the contract is made. However, where a trust is limited in this way and the period expires, the parties interested at that time can agree to another trust running for another maximum period.

Some examples of the Massachusetts trust.—The student may care to inquire further into some specific examples of these trusts. Well-known examples are. The New England Power Association, organized in 1926. Its consolidated balance sheet for 1937 showed a 6 per cent preferred stock issue outstanding of $65,645,700; $2 preferred stock outstanding in the amount of $620,416, and common stock of $50,614,346 outstanding. The securities are listed on the New York Curb Exchange. The Associated Companies (formerly the Mackay Companies) is a holding company controlling a cable line and the "Postal Telegraph System." It has preferred stock of $49,028,000 and common stock amounting to $41,380,400. Its securities are listed on the New York Stock Exchange. American Optical Company and Ludlow Manufacturing Associates are two examples of industrial concerns using the trust form of organization.[5]

[5] See "Works of Alexander Hamilton," Vol VII, page 838, for form of an agreement drawn by Alexander Hamilton (Sears, "Trust Estates as Business Companies," page 340) See Credit Mobilier v Commonwealth, (1870) 67 Pa. St 233, for the trust agreement under which the famous Credit Mobilier operated.

Capitalization and organization of trust.—In some States the amount of bonds which a corporation may issue is limited to a portion of its capital stock. The trust, however, labors under no such restriction. It may have as many classes of shares as it wishes, and any amount of preferred stock. Its whole form of organization is much more flexible than that of the corporation, the range of possibilities of form and organization being limited only by the desire and imagination of the organizers. It may have any number of trustees (most States require corporations to have three or more directors), the trustees need not be residents of the State of formation, and their meetings may be held in any State (a few of the State statutes require one or more resident directors for a corporation).

Permanency of management.—In a corporation, the management is subject to frequent change. Usually, new directors must be elected each year It is very frequently desirable—yes, in many cases essential—that the same management remain in control. For example, a minority interest may demand for their own protection that half of the board of directors be designated by them This is partially accomplished in a corporation through a voting trust, of which we shall speak later But a voting trust is legal only for a limited period of time—in New York and in most States, ten years; in Arkansas, five years. In the case of the common law trust, however, the management may be permanent. Indeed, if the stockholders of a Massachusetts trust wish to escape the liability of partners, they must exercise no control, and they cannot, therefore, be given the power to elect the trustees periodically. Provision may be made, if desirable, for the selection of a new trustee by the certificate-holders or by a class of them in case of the death, withdrawal, or removal of a trustee. By classifying the trustees and by providing that a vacancy in a certain class of trustees shall be filled by the corresponding class of stockholders, the minority may be assured of permanent representation.

Liability of trustees.—A trustee in such an association has much the same obligations to shareholders as a director of a corporation. In Hayes v. Hall, (1905) 188 Mass. 510, the court stated that "a trustee in the management of property held by him in trust shall not be permitted directly or indirectly to derive any personal advantage from its use or sale but must act solely for the interests of those beneficially inter-

ested." If he makes any profit, he must account for it to the shareholders

In managing trust property a trustee must use the judgment and care of a reasonably prudent man. If he fails to do so, he is liable for any resulting losses. Usually, however, the trust deed constituting a Massachusetts trust stipulates that the trustee shall be liable only for the result of his own gross or wilful negligence or bad faith. While this provision protects the trustee against loss because of failure to exercise what the law calls "the judgment of an ordinarily prudent man," it does not protect him if he uses the property of the trust for purposes other than those specified in the trust deed,[6] nor in cases where he shows "such reckless indifference to true interests of the trust as to amount to or partake of a wilful violation of duty"[7]

In dealing with outsiders, trustees are personally liable, unless they clearly indicate that they are acting as trustees and that only the trust property is liable. In contracts with third parties, trustees usually stipulate that the "creditor shall look only to the funds and property of the trust for all payments, and not to the trustees or shareholders personally" This stipulation has been held valid.[8] Furthermore, the trust deed itself usually provides that if the trustee shall ever become personally liable as trustee, not as a result of his acts in bad faith, he may be indemnified out of the trust property.

While in most States a director of a corporation is not entitled to any compensation unless such provision is made in the certificate of incorporation or by-laws or unless the shareholders consent, trustees in a business trust are entitled to reasonable compensation for their services, unless there is a contrary provision in the deed of trust. Usually, the trust instrument specifies what the compensation shall be.

Liability of cestuis.—It is well settled that the beneficiaries —the so-called shareholders—of the trust[9] are not personally liable for debts contracted or torts committed by the trustees. Creditors can look only to the trustees, or when

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[6] Digney v Blanchard, (1917) 226 Mass 335, 115 N E 424

[7] Warren v Pazolt, (1909) 203 Mass 328, 89 N E 381

[8] Rand v Farquar, (1917) 226 Mass 91, 115 N E 286

[9] The word "trust" is used here to indicate the ordinary relationship created when property is left to a trust company for named beneficiaries.

the trust deed so provides, as indicated above, only to the trust property. While shareholders of a trust are not personally liable, members of a partnership are. It is very frequently an important and difficult problem to distinguish between a trust and a partnership. Stated very briefly, the problem in any given case is. does the trust deed under which a business trust is formed constitute merely a trust deed or does it really go further and constitute the interested persons members of a partnership?

In Massachusetts, where the law concerning trusts as business associations has been most fully developed, it has been held that provisions in a trust agreement giving the shareholders power to remove the trustees without assigning any cause, and to appoint others to fill the vacancy, and to amend the declaration of trust, demonstrate that the association is a partnership and not a pure trust.[10] It appears, then, that if the shareholders have a right to control the trustees by the power to remove and elect trustees, or to elect them periodically, or if the shareholders have a right to manage the property themselves, the association will be considered a partnership, and the shareholders will be personally liable On the other hand, if the trustees act as principals and are free from the control of certificate holders, a trust is created and the shareholders are not personally liable.[11] In the latter case, shareholders have only the right to "compel the trustee to account and to charge him with the consequences of dishonesty or neglect and cause his removal for the one offense or the other."[12] This includes the right of each shareholder to receive his share of the income of the trust in accordance with the trust deed and his share of the corpus of the trust when it comes to an end.

In any event, even where the trust may be considered a partnership because of the control the shareholders may exercise over the trustees, the liability of the shareholders may usually be restricted by including in the trust deed, and consistently observing it, a clause similar to the following:

Neither the trustees nor the *cestuis que trustent* (shareholders) shall ever be personally liable hereunder as partners or otherwise, but for all

[10] Frost v Thompson, (1914) 219 Mass. 360

[11] Williams v Milton, (1913) 215 Mass 1

[12] Wrightington, "Unincorporated Associations," page 48, and cases there cited.

debts the trustees shall be liable as such to the extent of the trust fund only In all contracts or instruments creating liability, it shall be expressly stipulated by the trustees that the *cestuis que trustent* shall not be liable

Anyone dealing with the association, even though it might otherwise be considered a partnership, who has notice of this provision[13] or who expressly agrees to be bound by this provision, has no right of action against either the trustees or shareholders personally. This provision, however, would not relieve the shareholders of personal liability (if the association were held to be a partnership), in case of the commission of a tort by the trustees in managing the property, or if the trustees neglected to notify contract creditors and the latter had no information of the intention to limit liability to the amount of the trust estate If the association were a pure trust, that is, if the shareholders did not control the trustees through the right of removal and election, then the shareholders would be under no liability in any event—whether or not a clause limiting the liability of trustees and *cestuis* were included.[14]

Uncertain position of Massachusetts trust.—The Massachusetts trust as a form of business organization has thrived to a remarkable degree because it has most of the advantages of the corporation. It was described in 1912[15] as "more flexible, more economical, and more convenient than the corporation. Trustees can do business with more ease and rapidity than a board of directors. In particular [the trust] affords a convenient form of combining capital for the development and improvement of real estate," as the form of organization may be arranged to insure "a continuity of management and control which specially appeals to investors in real estate, and which cannot be secured by a corporation on account of the change of [directors] each year. Trustees are not changed as frequently as are directors of a corporation."

As the Massachusetts trust has grown as a form of business organization, it has become involved in considerable litigation which has shown that its exact legal status is not established. It has been treated by the courts as a corporation, as a partnership, and as a trust Texas designates the

[13] Bank of Topeka v Eaton, (1900) 100 Fed 8.

[14] See an excellent article by Calvert Magruder in 23 *Columbia Law Review* 423 It seems that Texas courts hold all business trusts the equivalent of partnerships as far as liability of interested persons is concerned.

[15] Report of Commissioners of Corporations in Massachusetts, January 17, 1912.

trust as a partnership, while Kansas regards the trust as a corporation that has failed to comply with the corporation laws Many States, however, still regard the Massachusetts trust as a pure trust, though one learned judge has said that business trusts are entities masquerading as pure trusts

Tendency to regard trusts as corporations.—Massachusetts trusts have come to be regarded as corporations under many taxing statutes, under statutes permitting suits in the firm name, under blue-sky laws, under the Federal Securities Acts, and under the Public Utility Holding Company Act of 1935.

In recent cases the courts have shown a tendency not to aid those who seek through the Massachusetts trust to obtain the advantages of a corporation, especially the advantage of limited liability, without complying with the corporation laws.[15a] The laws of many of the States define a corporation to include all associations and joint stock companies having powers or privileges of corporations not possessed by individuals or partnerships In some States the courts have held that Massachusetts trusts are corporations within the definition and that they must proceed in the same manner and pay the same fees as corporations to secure their authority to do business in the State. In one State, on the basis of this definition of a corporation, Massachusetts trusts are not permitted to do business in the State. In another State, such an organization must qualify under trust company laws Another State has prohibited the common law trust on the basis that there is no law in the State authorizing the association of parties under the management of trustees to issue certificates of stock and to engage in commercial enterprises.

Statutory recognition of Massachusetts trust.—Up to the present time only a few States have given Massachusetts trusts a statutory status. Massachusetts has given them a status as associations, not as trusts or partnerships. In that State the instrument or declaration of trust must be filed with the commissioner of corporations and with the clerk of every city or town in which the association does business.[16] The

[15a] In Brown v Bedell, (1934) 263 N Y. 177, 188 N E 641, the court said "It (the court) should not be solicitous to give corporate advantages without incorporation, or to extend the Massachusetts business trust doctrine of exemption from liability beyond properly defined lines"

[16] Massachusetts General Laws, 1932, Chapter 182. To same effect, Oklahoma Statutes, 1931, § 11,821.

filing fees are nominal when compared with the combined organization tax and filing fees paid by corporations. In 1916 Massachusetts also imposed an annual tax on dividends on shares in these associations. Oklahoma also has provided for the recording of the trust deed.

Doing business in other States.—An advantage formerly enjoyed by the Massachusetts trust was that it was considered able to do business in any State without formalities and without paying qualification fees to the States. This right, it was claimed, was guaranteed by the Constitution, which provides (Art IV, Sec. 2) that "the Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States." In a recent case,[17] however, the United States Supreme Court held that the trust, having attributes and functions of a corporation, may be treated as a corporation, and that it is therefore not protected as a citizen by the "privileges and immunities" clause; it was also decided that business trusts seeking to do business in foreign States must comply in the same manner as corporations. Although the statute under which the decision was rendered classed business trusts as corporations, the case is considered to have far-reaching effects. In many of the State statutes provision is made to include business trusts along with corporations, in no case has a business trust been held a citizen within the protection of the "privileges and immunities" clause.[18]

Advantages of the Massachusetts trust.—In many States corporations are forbidden to engage in certain activities. In a few States, for example, corporations may not deal in real estate, while in some they may not hold stock in other corporations. On the other hand, a trust may, like an individual or partnership, engage in any form of business[19] The

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[17] Hemphill v Orloff, (1927) 238 Mich 508, 213 N W 867, Aff'd 48 Sup Ct 577

[18] To this effect that a State cannot discriminate against trustees who are residents of other States, see State v Cadigan, (1901) 73 Vt 245, and State v. U S Express Co, (1900) 81 Minn 87

[19] In some States certain kinds of business are restricted to corporations, and statutes to this effect have generally been upheld as means for enabling the State better to control business affected by a public interest Banking and insurance are examples of such kinds of business These statutes probably are as effective against business trusts as against other forms of organization. See W M Fletcher, "Cyclopedia of the Law of Private Corporations," Vol 16, §8271

only limitation is that prescribed by the deed of trust which the organizers themselves are free to prepare.

In those States where the Massachusetts trust is not regarded as a corporation, trusts need not pay any organization fees upon formation. It is customary, however, to file the trust deed in a public office and to pay the filing fees, which are merely nominal. Moreover, in such States trusts are not required to file annual State reports, nor must they pay a franchise tax.[20] As previously mentioned, States have begun to tax Massachusetts trusts as corporations. In New York, since 1922, they must pay the same annual franchise tax as corporations

The Massachusetts trust is a voluntary association which does not, like a corporation, obtain a privilege or franchise from the State where it does business For this reason the legislatures find it difficult to regulate trusts to the same extent as corporations.

Other advantages of the Massachusetts trust are summed up on page 67

Disadvantages of the trust.—The great difficulty of the trust lies in the fact that the relationships which it creates are governed by the precedents of courts which are not uniform throughout the English-speaking jurisdictions. The Massachusetts trust is subject to different treatment in different jurisdictions. In fact, in many jurisdictions questions may arise that are entirely novel; what disposition the courts would make in an actual case brought before them is in doubt. Uncertainty of this kind

> " puzzles the will
> And makes us rather bear those ills we have
> Than fly to others that we know not of,"

such uncertainty is so inimical to honest administration that many lawyers advise strongly in favor of the corporation. Taxes are less burdensome than confusion.

The tendency of the courts not to permit trusts to exercise corporate rights without having complied with the corporation laws, and the possibility of the trust being regarded as a corporation that has not complied with the corporation laws, may subject the trust to penalties usually imposed upon

[20] For a discussion of the Massachusetts trust under the Federal Tax Laws, see pages 174 *et seq.*

corporations that do business in a State without a license. These penalties include fines, loss of the right to sue or defend in the State courts, invalidity of contracts, civil personal liability, and criminal liability of agents.

Form of Massachusetts trust agreement.—In order to make clear exactly what a Massachusetts trust agreement is, the following form is given. This deed of trust was very carefully drawn by eminent counsel and is generally regarded as a model

BOSTON PERSONAL PROPERTY TRUST[21]

THIS DECLARATION OF TRUST, made this tenth day of January, in the year eighteen hundred and ninety-three, by John Quincy Adams, of Quincy, Moses Williams, of Brookline, William Minot, Jr, and Abbott Lawrence Lowell, both of Boston, and Robert Sedgwick Minot, of Manchester, all in the Commonwealth of Massachusetts (hereinafter called the Trustees) witnesseth·

DESIGNATION

First. That this trust shall be designated the "Boston Personal Property Trust"[22]

I. TRUSTEES' DUTIES, POWERS AND LIABILITIES

DECLARATION, NOT A PARTNERSHIP, CESTUIS NOT LIABLE

Second. That the said Trustees shall hold all the funds and property (hereinafter called the trust fund), now or hereafter held or paid to, or transferred or conveyed to them or their successors as Trustees hereunder in trust for the purposes, with the powers and subject to the limitations hereinafter declared, for the benefit of the *cestuis que trustent,* and it is hereby expressly declared that a trust, and not a partnership, is hereby created, that neither the trustees nor the *cestuis que trustent* shall ever be personally liable hereunder as partners or otherwise, but that for all debts the trustees shall be liable as such to the extent of the trust fund only. In all contracts or instruments creating liability, it shall be expressly stipulated that the *cestuis que trustent* shall not be liable

PAYMENTS

Third In case any person proposes to pay by instalments, or at a future date, sums of money for interests in the trust fund, the Trustees shall have full power and discretion to call such payments upon such terms

[21] This agreement is reprinted from S R Wrightington, "Unincorporated Associations." It was construed in the leading Massachusetts case, Williams v. Milton, (1913) 215 Mass 1, 102 N.E 355 The trust agreement drawn by Felix Racksmann, involved in Crocker v Malley, (1919) 249 U. S 223, is generally considered to be a model.

[22] Where the business is carried on under a designation, such as the above, the trustees would be required to file the name in a public office, to comply with local statutes requiring the filing of trade name certificates.

and conditions as they see fit, and to receive the same either wholly or partly in cash, or in any property in which they are authorized to invest said fund.

Power of Investment, Personal Property, Ground Rents

Fourth (*a*) The Trustees shall have as full power and discretion, as if absolute owners, to invest and reinvest the trust fund (including any surplus and also income) in personal property, including bonds and notes or obligations secured upon real estate, and the decision of the Trustees as to what is personal property shall be final They shall have the like power of investment in the purchase and improvement of real estate in the cities of the United States of America, for the purpose of leasing the same upon long terms, or ground rents so-called, and all real estate so purchased shall be conveyed to them in joint tenancy as Trustees hereunder

Power of Sale

(*b*) The Trustees shall have full power and discretion to sell, transfer, and convey from time to time, at public or private sale, any part or all of said trust fund, upon such terms and conditions as they see fit, and to invest the proceeds in the same manner, and upon the same trusts as the original fund.

Powers as to Real Estate

(*c*) The Trustees shall have absolute control over and power to dispose of all real estate held by them at any time under this Trust, as if they were the absolute owners thereof, including the power to sell and convey, as above set forth, to improve, to lease or hire for improvement or otherwise, for a term beyond the possible termination of this trust, or for any less term, either with or without option of purchase, to let, to exchange, to release, and to partition

Power to Borrow and Mortgage

(*d*) The Trustees may borrow money, for such time and upon such terms as they see fit, on mortgage of any real estate held by them hereunder, and may give mortgages therefor, either with or without power of sale, but never for more than sixty per cent of the value, in their judgment, of the property so mortgaged.

Power to Borrow and Pledge

(*e*) The Trustees shall also have power at any time to borrow money, and to pledge, as collateral security for such loan, any personal property belonging to the trust fund, provided, however, that no loan shall be contracted for, so that the aggregate amount of such loans outstanding shall at such time exceed, in the judgment of the Trustees, twenty-five per cent of the total amount of the personal property of the trust fund.

Execution of Instruments

(*f*) The execution of all contracts, of all conveyances and transfers, and of all other instruments relating to the trust fund or any part thereof, by any three Trustees, shall always be sufficient The acting Trustee or

Actuary or Treasurer shall have full power to cancel and discharge mortgages, by deed or otherwise, on the payment or satisfaction thereof

PURCHASERS, ETC, NOT LIABLE

(*g*) No purchaser, lender, corporation, association or officer or transfer agent thereof, dealing with the Trustees, shall be bound to make any inquiry concerning the validity of any sale, pledge, mortgage, loan, or purchase purporting to be made by the Trustees, or be liable for the application of money paid or loaned

RECORDS, DEPOSITARY

Fifth The Trustees shall constitute as their Depositary such trust company in the city of Boston as they shall from time to time select, and hereby declare that they have selected for such Depositary the State Street Safe Deposit & Trust Company Such Depositary shall have the custody of this declaration of trust, of any and all instruments altering or adding to the same, or terminating the trust, or containing the resignation of one or more Trustees, or appointing one or more Trustees to fill vacancies, or appointing a Trustee attorney for a co-Trustee, or otherwise affecting this declaration of trust, or the duties, powers, or liabilities of the Trustees Such Depositary shall be bound to deliver on demand to any new Depositary selected by the Trustees, all such documents and records, and also to record, at the request of the Trustees, any such document in any place of public record selected by them, whereupon the duty of such Depositary as to such recorded document, and its liability therefor hereunder, shall cease, and it shall deliver to the Trustees all papers relating to the same. Copies of all documents and records in the custody of such Depositary, duly certified, and certificates as to who are the Trustees, or *cestuis que trustent*, or the like, duly signed by the President, Treasurer, or Actuary of such Depositary, shall be conclusive upon all questions as to title or affecting the rights of third persons, and in general shall have all the effects of their originals.

MANAGEMENT AND COMPENSATION

Sixth. The Trustees may from time to time hire suitable offices for the transaction of the business of the Trust, appoint, remove, or reappoint such officers or agents (including a Depositary, and also agents to procure proposals for payments for interests herein) as they may think best, define their duties, and fix their compensation The compensation of the Trustees shall not at any time exceed five per cent of the gross income of the Trust Fund, and one per cent of the amount distributed or conveyed upon final distribution or conveyance

DIVIDENDS, SURPLUS

Seventh The Trustees shall declare dividends from the net income of the Trust Fund among the *cestuis que trustent* quarterly, or oftener, if convenient to the Trustees, and their decision as to amounts of dividends, and as to using therefor any portion of the surplus fund, shall be final They may set aside from time to time such portion of the net income as shall not be required for dividends for a surplus fund.

Power to Decide Between Income and Capital

Eighth. The Trustees may charge all brokers' and agents' commissions to Income or Capital, as they see fit They shall have the right to treat as income such portion of the price of stock bought or sold between dividend days as fairly represents accrued dividends reckoned by way of interest, but never at a higher rate than six per cent per annum, on the price paid or received In general their decision as to what constitutes Capital or Income, or shall be credited or debited to Capital or Income, shall be final.

Annual Account

Ninth The Trustees shall render an account annually or oftener, if convenient to them, and shall, upon request, deliver or mail a copy to each *cestui que trust*

Resignation, Vacancy, New Appointment, Temporary Absence, Power of Attorney

Tenth Any Trustee may resign his trust by a written instrument signed and sealed by him, and acknowledged in the manner prescribed for the acknowledgment of deeds, and such instrument may be recorded in the Registry of Deeds for the County of Suffolk, or deposited with such Depositary as the Trustees shall from time to time select

Any vacancy occurring from any cause at any time in the number of said Trustees shall be filled by the remaining Trustees Until such vacancy is filled, or while any Trustee is absent from the Commonwealth of Massachusetts, or physically or mentally incapable, by reason of disease or otherwise, the other Trustees shall have all the powers hereunder, and the certificate of the other Trustees of such vacancy, absence, or incapacity shall be conclusive In case of such vacancy or of appointment of a new Trustee or Trustees, the Trust Fund shall immediately vest in the remaining Trustees or in the new Trustee or Trustees, jointly with the remaining Trustees, as the case may be And any Trustee may, by power of attorney, delegate his powers, for a period not exceeding six months at any one time, to any other Trustee or Trustees hereunder, provided that in no case shall less than three Trustees personally exercise the other powers hereunder (except in case of discharge of mortgages, as hereinbefore provided).

The term "Trustees" used in this agreement shall be deemed to mean those who are or may be Trustees for the time being.

Trustees' Liability, No Bond Required

Eleventh. Each Trustee shall be responsible only for his own wilful and corrupt breach of trust, and not for any honest error of judgment, and not one for another. No Trustee shall be required to give a bond.

II. RIGHTS AND LIABILITIES OF CESTUIS QUE TRUSTENT, NOTICES

Twelfth. Notices delivered personally, or mailed with prepayment of postage seven days beforehand to any *cestui que trust*, or to his attorney

duly designated for the purpose, at the residence stated by him or in the certificate, or to the address given by him or them from time to time to the Trustees, shall be binding

FORFEITURE OF PAYMENTS

Thirteenth In case any *cestui que trust* neglects to pay any instalment within the time specified in the call therefor, the Trustees may, if they see fit, declare any amount of his previous payment or payments to be forfeited

CERTIFICATES, CONVERTIBLE SCRIP, LOST CERTIFICATES

Fourteenth The Trustees shall issue a certificate, in such form as they shall deem best, to each person who shall pay them the sum of one thousand dollars or multiple thereof, for an interest in the Trust Fund But no certificate shall be issued for any less sum than one thousand dollars, at par value. The Trustees may also from time to time, if they see fit, issue scrip of the par value of one hundred dollars or multiples thereof, convertible into certificates in sums of one thousand dollars or multiples thereof, and bearing interest, and on such other terms and conditions as they shall deem best.

In case of the loss or destruction of a certificate or scrip, the Trustees may issue a duplicate thereof, on such terms as they deem proper.

TRANSFER OF CERTIFICATES

Fifteenth The interests represented by the certificates may be transferred on the books of the Trustees by the person named therein, or his legal representative, upon the surrender of the certificate, and a new certificate shall be issued to the transferee, who shall thereupon become a *cestui que trust*. But no such interest shall be sold until the holder thereof (including assignees in insolvency or bankruptcy, or for benefit of creditors, and holders by process of law or otherwise, except as hereinafter stated) shall have first in writing offered it for sale to the Trustees, who shall, as such Trustees, have the option for ten days after the receipt of such offer of buying the same at not more than the last preceding appraisal made by them, such appraisal to be made annually or oftener as they shall deem best Interests so purchased by the Trustees may be held as part of the Trust Fund, or sold by them at their discretion.

Devises by will, distribution of the assets of deceased persons according to law, and distribution of trust funds among those entitled thereto upon the termination of trusts, shall not be deemed sales for the purposes hereof

NO ASSESSMENT OR PERSONAL LIABILITY

Sixteenth No assessment shall ever be made upon the *cestuis que trustent*, nor shall they ever be personally liable in any event, or have any rights hereunder except as herein defined

BOOKS OPEN TO INSPECTION

Seventeenth. The books of the Trustees shall always be open to the inspection of the *cestuis que trustent*

INCREASE OF CAPITAL, RIGHTS

Eighteenth. The Trustees may from time to time, at their discretion, invite and receive payments for interests in the Trust Fund in cash or in property, as hereinbefore provided, for the purpose of increasing the capital of the Trust Fund, giving preference, if they see fit, upon such terms and conditions as they shall deem best, to existing *cestuis que trustent.* All payments shall be subject to the terms of this Declaration of Trust.

III DURATION AND TERMINATION OF TRUST

Nineteenth At and upon the expiration of twenty years after the death of the last survivor of the following-named persons [23]

Walter Abbott, son of Jere Abbott of Boston,
George C Adams, son of John Quincy Adams of Quincy;
Oliver Ames, son of Frederick L Ames of Easton,
F Reginald Bangs, son of Edward Bangs of Wareham;
Boylston A Beal, son of James H. Beal of Boston;
Robert P Blake, son of S Parkman Blake of Boston;
Causten Browne, Jr., son of Causten Browne of Boston;
Edmund D Codman, son of Robert Codman of Boston,
David H Coolidge, Jr , son of David H. Coolidge of Boston;
Philip Dexter, son of William S Dexter of Boston,
John M. Howells, son of William D Howells of Boston;
Laurence Minot, son of William Minot of Boston;
William Minot, 3d, son of William Minot, Jr , of Boston,
James Otis Porter, son of Alexander S Porter of Beverly;
Abbott Lawrence Rotch, son of Benjamin S Rotch, late of Milton,
James J Storrow, Jr , son of James J Storrow of Boston;
Samuel Wells, Jr., son of Samuel Wells of Boston,
George Putnam, son of William L. Putnam of Boston;
Gladys Williams, daughter of Moses Williams of Brookline;
Robert S. Minot, Jr , son of Robert S Minot of Manchester;

or at such earlier time as hereinafter provided, the Trustees shall terminate this trust by dividing the Trust Fund, or the proceeds thereof, among the *cestuis que trustent,* being first duly indemnified for any outstanding obligation or liability, and shall thereupon be forthwith discharged

ALTERATION OF TRUST, TERMINATION OF TRUST, CONVEYANCE OF TRUST FUND

Twentieth The Trustees may, with the consent of the three-fourths in interest of the *cestuis que trustent,* alter or add to this declaration, or terminate this trust, and if it seems to them judicious so to do, they may, with like consent, convey the Trust Fund to new or other Trustees, or to a corporation, being first duly indemnified for any outstanding obligation or liability. The instrument setting forth such alteration, addition, termination, or conveyance shall be signed by at least three of the Trustees and recorded in said Registry of Deeds, or deposited with such Depositary

[23] In New York only two persons' lives can measure the duration of the trust.

as the Trustees shall select Such instruments shall be conclusive of the existence of all facts and of compliance with all prerequisites necessary to the validity of such alteration, addition, termination, or conveyance, whether stated in such instrument or not, upon all questions as to title or affecting the rights of third persons

PROVIDED, HOWEVER, and it is especially declared, that the Trustees shall be under no obligation to terminate this Trust or convey the Trust Fund, except as hereinbefore provided

IN TESTIMONIUM

Twenty-first IN WITNESS WHEREOF, the said Trustees have hereunto set their hands and seals the day and year above written in duplicate.

Signed and sealed in presence of

Signed CHARLES H SHRIVER

Signed	JOHN QUINCY ADAMS	(Seal)
	MOSES WILLIAMS	(Seal)
	WILLIAM MINOT, JUNIOR	(Seal)
	A LAWRENCE LOWELL	(Seal)
	ROBERT S. MINOT	(Seal)

COMMONWEALTH OF MASSACHUSETTS } ss
SUFFOLK

BOSTON, January 14, 1895.

Then personally appeared the above named John Quincy Adams, Moses Williams, William Minot, Junior, A Lawrence Lowell, Robert S. Minot, and acknowledged the foregoing instrument to be their free act and deed.

Before me,

Signed CHARLES H SHRIVER,
Notary Public.

A true copy of the original on file with this Company

STATE STREET TRUST CO ,
A L CARR, *Treasurer*

Chapter VI

CORPORATIONS—ORGANIZATION

The corporation.—The corporation is a device that for most purposes is regarded as a separate artificial person. The people who become members of a corporation are therefore hardly to be called the corporation—they own it. On the other hand, *it* owns the corporate property.

More technically described, a corporation is an organization set up with the consent of the State. The State authorizes its existence and as long as it complies with the provisions of the law it continues to exist as a recognized person with the right to own property; it may bring actions to protect its rights and may do such ordinary things as are necessary in the conduct of its business.

A modern writer on corporations defines the corporation as follows:

> A private corporation is a voluntary union of persons, joined together by written articles of association or incorporation under legislative authority, or by special statute on proper application to the legislature, to accomplish some pecuniary or ideal purpose authorized by the governing body of a State. Its leading features are that it has a continuous succession during the period described for its existence, and an individual name by which it may enter into contracts and sue and be sued, acting as a unit in respect to all matters within the scope of the purposes for which it is created, and a distinct existence or legal entity separate and distinct from the natural persons composing it. The essential idea of a corporation is that it has "the capacity to exist and act within the powers granted, as a legal entity, apart from the individual or individuals who constitute its members."[1]

The time-honored definition of a corporation is that of Lord Coke, written in 1683:

> A corporation aggregate of many is invisible, immortal, and rests only in intendment and consideration of the law. They cannot commit treason, nor be outlawed, nor excommunicated, for they have no souls, neither can they appear in person, but by attorney. A corporation aggregate of many can't do fealty, for an invisible body can neither be in person nor swear, it is not subject to imbecilities or death of the natural body and divers other cases.

[1] "Thompson on Corporations," Second Edition, Sec. 2.

Another definition is that of Chief Justice Marshall:

> A corporation is an artificial being, invisible, intangible, and existing only in contemplation of law. Being the mere creature of law, it possesses only those properties which the charter of its creation confers upon it, either expressly or as incidental to its very existence. These are such as are supposed best calculated to effect the object for which it was created. Among the most important are immortality, and if the expression may be allowed, individuality, properties by which a perpetual succession of many persons are considered as the same, and may act as a single individual. They enable a corporation to manage its own affairs, and to hold property without the perplexing intricacies, the hazardous and endless necessity of perpetual conveyances for the purpose of transmitting it from hand to hand. It is chiefly for the purpose of clothing bodies of men in succession with these qualities and capacities that corporations were invented, and are in use. By these means, a perpetual succession of individuals are capable of acting for the promotion of the particular object, like one immortal thing. (Dartmouth College Case, 4 Wheaton 636.)

Classification of corporations.—Corporations are variously classified for various purposes. The more important classifications we shall explain briefly.[2]

On the basis of the relationship to the State, corporations are classified as public, public service, moneyed, and private.

Public corporations include all subdivisions of the State, such as cities, villages, tax districts, and the like. A study of their financial operations is entirely without the purview of this book.

The *public service corporations*, sometimes called *quasi-public corporations*, or more simply *public utilities*, include the railroads, gas, electric, street railway, interurban electric railway, telephone and telegraph, hydro-electric, central heating, water, and in some cases irrigation and other corporations. The common feature is a special franchise to use public property for private use, though in some few cases all the property is owned directly by the company. They are now generally under the control of public service commissions, which regulate not only the ordinary operations of the company, but prescribe uniform systems of accounting and pass upon proposed security issues. Public utility holding companies and their subsidiaries are placed under the control of the Securities and Exchange Commission by the Public Utility Holding Company Act of 1935.

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[2] For the classification under the New York law, see C. W. Gerstenberg, "Materials of Corporation Finance," pages 24–5.

Moneyed corporations are the banks and insurance corporations which are usually organized under special banking and insurance laws and are subject to close supervision by banking and insurance departments. In this class would also come investment companies in those States in which such companies are subject to special control.

Private corporations are the ordinary business corporations that are engaged in common manufacturing and mercantile pursuits. They are the simplest to organize and to manage and are usually freer from governmental control than are the other corporations

From an investment viewpoint it is necessary to classify corporations from the standpoint of the nature of their business, in order that companies with like characteristics entailing similar risks and similar operating problems may be readily compared. Investment houses usually divide business corporations as follows. industrials, public utilities, money corporations, extractive businesses such as mining and oil companies, railroads, and shipping corporations. Foreign[3] corporations, that is, corporations whose principal business is in foreign lands, are usually kept by themselves The securities of public corporations are usually called "municipals."

A very simple classification is that into stock and non-stock corporations. Most corporations engaged in business for profit are stock corporations; that is, their ownership is called stock, which is divided into negotiable units called shares. Non-stock corporations include, besides the public corporations, such membership corporations as incorporated clubs, fraternities, museums, and churches. Usually special laws are passed to regulate the management of these various non-stock corporations.

A classification on the basis of the place of incorporation is important since it affects the relationship of the corporation to governmental control. Companies are designated "domestic" in the State in which incorporated, "foreign" in other States of the United States; and those that were organized in

[3] Technically, these corporations are "alien"; they would be so classified in legal literature (See explanation of "alien" on page 81) In investment literature, however, corporations designated as foreign are those whose business is chiefly outside the country and whose corporate existence is owed to a foreign sovereign.

other lands are designated as "alien." Except in times of war, and except in connection with Federal taxes, foreign and alien corporations are treated alike in this country.

A corporation is not a citizen under that provision of the United States Constitution which says that the "Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States."[4] Hence one State may prevent the corporations of another State from doing business *within* the State, it cannot, however, keep the corporations out of the State, for if the corporations merely do business from an outside State into the State in question, their business is interstate business, which is entirely within the control of the Federal government. Thus company *A* may do business from State *X* to State *Y* without *Y*'s consent, but it cannot do business from one point in *Y* to another point in the same State without *Y*'s consent. Ordinarily, corporations of other States are permitted to do business within the State upon payment of proper taxes and the filing of certain documents necessary for identification. Moreover, they are usually required to designate some person as agent to receive service of legal papers and are frequently placed under certain disadvantages, such as being made subject to attachment of their property before judgment is obtained against them.

How corporations are organized.—At one time corporations were organized by the enactment of a bill in the legislature which read in effect, "Be it enacted by the people of the State of ———, by legislature in Senate and Assembly represented, that (here followed the names of the interested persons) be and they hereby are constituted a body corporate under the name of (here the corporation name) for the purpose of (and here followed the objects of the corporation)."[5] Then were added other provisions regulating the company and giving it certain powers, such as the power to pass by-laws, issue stock, and so on. When the bill was passed by both houses and signed by the governor, the incorporators met and "accepted" the charter contained in the act of the legislature,

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[4] A corporation is a "citizen," however, for purposes of bringing a suit or being sued in a Federal court under the provisions of Article III of the Constitution

[5] For an example, see the charter of the General Electric Company in C. W. Gerstenberg, "Materials of Corporation Finance," page 26

TAXES AND

STATE	ORGANIZATION TAX FILING FEES AND MISCELLANEOUS EXPENSES	2 INHERITANCE TAXES ON TRANSFER OF SHARES HELD BY NON RESIDENT
Delaware	(Based on authorized capital stock) Par Value Stock One cent for each share of authorized capital stock having par value up to and including 20 000 shares one half a cent for each such share in excess of 20 000 shares and up to and including 200 000 shares and one fifth of a cent for each such share in excess of 200 000 shares. Each $100 of par value is deemed one share for initial tax purposes No Par Value Stocks One half cent for each share of authorized capital stock without par value up to and including 20 000 shares one fourth of a cent for each such share in excess of 20 000 shares up to and including two million shares and one fifth of a cent for each such share in excess of two million shares. Minimum $10 00 Recording indexing miscellaneous fees, approximately $[illegible]	No tax
Pennsylvania	(Based on authorized capital stock) Par value stock: Bonus tax: 1/5% of the authorized capital stock Certificate of Incorporation: $50 for issuing same Publication: Approximately $15 00 No par stock: Taken at stated value and taxed at same rate as par stock.	Shares owned by non resident decedents not taxed unless shares have acquired a business situs in the state, or are owned by a non-resident of the United States
Nevada	(Based on authorized capital stock) On par value stock, 10c per $1,000 on first $1 000,000 plus 5c per each additional $1 000 over $1,000,000 but not exceeding $10,000,000, and 2c for each $1,000 over $10,000 000 10c for each 1 000 shares of non par value capital stock Minimum, $25 Filing fees and miscellaneous expenses $15	No tax
Maryland	(Based on authorized capital stock) $1,000 000 or less, 20c per $1 000 plus $150 for each additional $1 000,000 or fraction thereof up to and including $5,000,000, plus $20 per $1 000,000 or part thereof over $ 000 000 Non par value shares: Valued at $100 each for tax purposes Minimum $20 Filing fees and miscellaneous expenses, $15	No tax
New Jersey	(Based on authorized capital stock) 20c per $1,000 of authorized stock having par value 1c per share for non par value shares Minimum, $25 Filing fees and miscellaneous expenses, approximately $15	No tax
New York	(Based on authorized capital stock) 1/20th of 1% of the par value Non par value shares 5c per share Minimum, $10 Filing fees, $40	No tax
Illinois	Initial license fee of 1/20 of 1% of the value expressed in dollars of the entire consideration received by the corporation for or on account of its issued shares reported to the secretary of state in its first report of issuance of shares Issuing certificate of incorporation—$[illegible] Recording [illegible] Initial Franchise Tax—rate 1/12 of 1/20 of 1% for each calendar month or fraction thereof between date of issuance of shares reported to the Secretary of State in first report of issuance of shares and the first day of July of the next succeeding calendar year of that proportion of the sum of its stated capital and surplus which the sum of (1) the value of its property located in Illinois and (2) the gross amount of business transacted at or from places of business in Illinois bears to the sum of (1) the value of all its property wherever located and (2) the gross amount of its business wherever transacted	Shares owned by non resident decedents not taxed unless shares have acquired a business situs in the state.
Massachusetts	(Based on authorized capital stock) 1/20th of 1% of total amount of authorized capital stock with par value No-par value shares: 1c per share for all authorized no-par value shares Minimum $50	Shares owned by non resident decedents not taxed unless shares have acquired a business situs in the State or are owned by a non resident of the United States.

accepted subscriptions, and issued stock, and the corporation was complete. This was called incorporation by special act of the legislature. The method is only rarely used nowadays.

A new method of incorporating has therefore been devised.[6] The State passes a general law providing that any group of

[6] See C. W Gerstenberg, "Materials of Corporation Finance," page ix of the Introduction and pages 31–42

REPORTS

3 ANNUAL FRANCHISE TAX	4 STAMP TAX ON TRANSFER OF SHARES	5 REPORTS DUE
The [illegible] of amounts determined under the two following methods: (1)—Based on authorized shares (with or without par value) [illegible] $5 [illegible] $10 [illegible] [illegible] (2)—Based on assumed no-par capital (assumed no par capital = shares without par value × $100) When [illegible] par value capital is $25 000 [illegible] $5 [illegible] $10 [illegible] [illegible] [illegible] $150 for each $1 000 000 or fraction thereof in excess of $1 000 000 of the assumed par value capital [illegible] [illegible] If assumed par value capital is less than $1 000 000 [illegible] Tax on $100 Minimum $[illegible] [illegible] $5 Inactive [illegible] ½ regular tax.	None	Annual report due first Tuesday in January Filing fee, $2 Information Returns on or before March 15
Capital stock tax: Actual value of capital stock at end of each tax year × [illegible] × .005 Corporate loans tax [illegible] Income tax [illegible] [illegible] Federal Government and [illegible] to Pennsylvania [illegible] to the following rules ⅓ of remainder × Value of tangible property within State / Value of all tangible property [illegible] ⅓ of remainder × Wages, salaries, commissions, etc. within State / Total wages, salaries, commissions, etc. ⅓ of remainder × [illegible] Receipts / Total Gross Receipts If only two rules are applicable [illegible] Mercantile License Tax—Rate varies with nature of [illegible]	2c per $100 or fraction thereof of the face value of the shares if shares have par value; no par shares, 2c each	Capital stock tax report: Due March 15th if calendar year is used, otherwise [illegible] days after close of fiscal year Corporate loans tax report: Due same as capital stock tax report. Registration Report: Due after annual meeting Income tax return: Due on or before April 15th or if on a fiscal year basis [illegible] days after return to Federal Government Mercantile License Tax Return—July 1st, except in Philadelphia on May 1st
Filing annual report $5	None	Report due within 60 days after organization and on or before July 1st annually, listing officers, directors and resident agent
(Franchise tax: Based on issued, outstanding and/or subscribed for capital stock as of January 1st) Up to and including $5 000 $10 plus $1 per $1 000 or part thereof on next [illegible] plus $1 per $1 000 or part thereof on next $50 000 plus $[illegible] for next $150 000 plus $[illegible] for the next $250 000 plus $10 for the first $[illegible] plus $60 for each $1 000 000 or part thereof on the next $5 000 000 plus $[illegible] for each additional $[illegible] 000 000 or part thereof Non par value shares [illegible] at $100 each for taxing purposes [illegible] a minimum tax of $10 must be paid LICENSE TAX [illegible] to Maryland	None	Annual report due on or before March 15 Income tax report due on or before March 15th
(Based on capital stock issued and outstanding) 1/10th of 1% on first $[illegible] 1/[illegible] of 1% on next $[illegible] $50 for each additional $1 000 000 or part thereof Non par value shares [illegible] NOTE: [illegible] Minimum tax $ [illegible]	None	Annual report due 30 days after time set for Annual Election of Directors Filing fee, $2 Annual franchise tax report due first Tuesday in Feb
Pay whichever is the highest of the following: 1 [illegible] New York State [illegible] 2 [illegible] 3 [illegible] 4 [illegible] [illegible]	5c per share whether par or no par value unless selling price is $20.00 or more per share and in that event tax is 4c per share	Annual Franchise Tax report of real estate and holding companies due between January 1 and March 1 other corporations on or before May 15
FRANCHISE TAX [illegible] Minimum tax—$10 00 CAPITAL STOCK TAX Rate varies with local property [illegible] in which corporation has its principal office RETAIL SALES TAX—[illegible] of gross receipts	None	Annual franchise tax report due between January 15 and February 28 Capital stock tax return due May 1st Retail sales tax Monthly returns
Corporation Excise Tax: $5 per $1 000 on [illegible] plus [illegible] of net income [illegible] 1/20 of 1% of fair value of capital of business corporations [illegible] Massachusetts [illegible] greater [illegible]	2c per $100 or fraction thereof of the face value of certificate No-par value stock, 2c per share	Annual Report [illegible] Filing fee $10 Corp. Excise Report 10th day of April. Information Returns due March 1.

persons executing the proper papers and filing them in the proper offices, at the same time paying the proper fees, thereupon shall create the corporation. The statutes have been made very complete in respect to the details of organization and management and in respect to the rights and liabilities of the various persons interested. From time to time these rules will have to be referred to in this book, but at present

INCORPORATORS, STOCKHOLDERS AND DIRECTORS

STATE	6 INCORPORATORS (1) *Number* (2) *Residence* (3) *Qualifications* (4) *Place of meeting*	7 STOCKHOLDERS (1) *Residence* (2) *Place of meeting* (3) *Maximum liability* (4) *Is cumulative voting permitted?*	8 DIRECTORS (1) *Number* (2) *Residence* (3) *Qualifications* (4) *Place of meeting*
Delaware	(1) 3 or more (2) No restrictions (3) Natural persons (4) Anywhere	(1) No restrictions (2) Within the State unless by laws provide otherwise (3) Unpaid portion of subscription (4) If provided for in charter	(1) Three or more (2) No restrictions (3) As certificate of incorporation or by laws provide (4) As by laws provide, within or without the State
Pennsylvania	(1) 5 or more. (2) No restriction (3) Natural persons of full legal age Two-thirds must be citizens of the United States and each must subscribe to at least one share of stock (4) Anywhere	(1) No restrictions (2) Within or without the state as the by laws provide Unless by laws provide otherwise shareholders meetings must be at registered office within state (3) Liable for unpaid balance of subscription and to amount of stock for salaries and wages due for services of laborers and employees (suit must be brought within six months after salaries and wages become due) (4) Required by a statute	(1) Minimum 3 (2) No restrictions (3) As by laws provide (4) Where by laws provide, within or without the State
Nevada	(1) 3 or more (2) No restrictions (3) No provision (4) Anywhere	(1) No restrictions (2) As charter or by laws provide, within or without the State (3) Unpaid portion of subscription (4) If provided for in charter	(1) Three or more (2) No restrictions (3) Full age, at least one a citizen of the U S (4) As charter or by laws provide, within or without the State
Maryland	(1) 3 or more (2) No restrictions (3) Must be adult persons (4) Unnecessary to hold an incorporators meeting. (Organization meeting may be held by the board of directors)	(1) No restrictions (2) Within or without the state as provided in by laws, without the State only when stockholders consent or all stockholders are non residents (3) Unpaid portion of subscription (4) If provided for in charter or by laws.	(1) Three or more (2) No restrictions (3) No restrictions (4) As by laws provide, within or without the State
New Jersey	(1) 3 or more (2) No restrictions (3) Natural persons Must be subscribers to the stock (4) No statutory provision (Practice is to hold meetings in the State)	(1) No restrictions (2) Within the State unless otherwise provided for in the certificate of incorporation or an amendment, or the by laws (3) Unpaid portion of subscription (4) If provided for in charter	(1) Three or more (2) No restrictions (3) Must be stockholders or stockholders in corporation holding 25% or more of the stock (4) As charter or by laws provide, within or without the State
New York	(1) 3 or more (2) One must be a resident of New York (3) Two-thirds must be citizens of the U S ; all must be natural persons of full age and subscribers to the stock (4) In New York	(1) No requirements (2) Within the State (3) Unpaid portion of subscription plus amounts due for wages, with limitations (4) If provided for in charter	(1) Three or more (2) One must be a citizen of the U S and a resident of New York (3) Must be stockholders unless charter or by laws otherwise provide (4) If only within state, charter or by laws must so provide
Illinois	(1) 3 or more (2) No restrictions (3) Natural persons of full age and subscribers to the shares (4) Anywhere	(1) No requirements (2) Within or without the state as provided in by laws In absence of any by law provision shareholders meetings must be held at registered office within state. (3) Unpaid portion of subscription (4) Required by statute.	(1) Three or more (2) No restrictions (3) As articles of incorporation or by laws provide (4) Within or without the State
Massachusetts	(1) Three or more (2) No restrictions (3) Natural persons, subscribers to the stock (4) Within State	(1) No restrictions (2) Within the State (3) Unpaid balance of subscription and unpaid wages, with limitations (4) No provisions	(1) Three or more (2) No restrictions (3) Must be stockholders unless by laws otherwise provide (4) Within or without State

we shall outline only very briefly the organization and management of a corporation.

State of incorporation.—Since, as we have indicated in the previous section, the law governing corporations in America is largely statutory, and since the statutes vary from State to State, the projectors of the corporation should be very careful in incorporating the company to select a State where the

POWERS OF CORPORATION

9 Increase or decrease in number of directors	10 Scope and purpose permitted under the charter	11 Restrictions in selecting a corporate name	12 (a) Duration (b) Limitation of amount of indebtedness
The by laws provide for the number of directors If provision is made in the charter giving directors power to amend by laws, the directors can change the number	Broad powers any purpose or purposes except banking and Public Utilities to be operated within Delaware	Must contain one of the following words: [illegible] company corporation [illegible] union [illegible] or limited [illegible] Use of word trust is prohibited except for corporations under supervision of State Bank Commissioner	(a) Perpetual or limited (b) No statutory limitation
Number to be prescribed by the by laws; except as otherwise provided in by laws, number of directors shall be same as stated in articles of incorporation; number may be changed by amendment of by laws	Any lawful purpose or purposes	[illegible]	(a) Perpetual or limited (b) No statutory limitation
The certificate or articles of incorporation or the by laws shall provide for the number of directors If provision is made giving directors power to amend by laws, the directors may change number	Broad powers any purpose or purposes except a trust, banking or building and loan [illegible] insurance surety express and railroad companies may be formed provided such business is not transacted [illegible] until the laws affecting the right [illegible] are complied with and provided further that by so incorporating it shall not infringe the laws of any other State or country in which they intend to do business	Shall end with word incorporated limited [illegible] or Ltd or contain one of the following words association company corporation club society syndicate union Co, Corp, Synd	(a) Perpetual or limited (b) No statutory limitation
The charter provides for the number of Directors in the first instance but the by laws may change the number or may give power to the directors to increase their number	Broad powers, any purpose or purposes except municipal corporations and banks	Such as will indicate that it is a corporation Name should begin with word The and end with company or contain words corporation or incorporated Word trust may be used (Company may not be preceded by and Limited or Ltd is acceptable—by ruling of Attorney General)	(a) Perpetual (b) No statutory limitation
The by laws provide for the number of directors If provision is made in the charter giving directors power to amend by laws, the directors would then have power to change the number	Fairly broad powers, any purpose or purposes, except banking, building & loan, surety, insurance, and public service Railroad, telephone and telegraph companies operating outside the State are permitted to organize under the General Corporation Act.	Shall not contain words "Insurance," "trust company," "Trust," "Bank," "safe deposit"	(a) Perpetual or limited (b) No statutory limitation
The charter provides for the number of directors, and to increase or decrease that number an amendment must be filed	Broad powers, any purpose or purposes except banking, insurance, railroad and transportation	[illegible]	(a) Perpetual or limited (b) No statutory limitation
The by laws provide for the number of directors; number may be increased by amendment of by laws; directors have power to make, alter, amend or repeal by laws unless reserved to the shareholders by the articles of incorporation	Any lawful purpose or purposes except for the purpose of banking or insurance or the operation of railroads Railroads which have the major portion of their system within the metropolitan area of cities of at least 800,000 inhabitants are permitted	Shall contain the word corporation" company" incorporated" or limited" or shall end with an abbreviation of one of said words	(a) Perpetual or limited (b) No statutory limitation
By laws fix number which may be changed by amendment thereof	Broad powers, any purpose or purposes except banking, credit union, surety, indemnity or safe deposit companies, insurance railway telephone, telegraph, gas electric light, heat and power canal or water companies and cemetery and crematory companies	Name must indicate it is a corporation and be approved by the corporation commissioner	(a) Real Estate Corporations limited by statute to 50 years all others perpetual unless limited by charter (b) No provision

laws are not unfavorable.[6a] Only one basic rule can be given

[6a] The corporation laws of one State may grant the corporation and its board of directors powers that are not granted by the laws of other States Delaware, for example, is the most popular incorporating State because it is most liberal from the standpoint of the corporation managers The broad powers permissible in certain States have led to abuses resulting in unfairness to investors and in economic disturbances which many believe will be adequately remedied only by Federal control of corporations through Federal incorporation and licensing Thus far the support necessary to effect such legislation has been lacking.

CAPITAL

STATE	13 (1) AUTHORIZED CAPITAL STOCK (2) CLASSES OF STOCK	14 PAR VALUE OF STOCK
Delaware	(1) Minimum, none Maximum, none (2) Any number	Par value of any amount Non par value shares permissible for all classes
Pennsylvania	(1) No maximum or minimum amount prescribed by statute (2) Any number, one or more	Par value of any amount Non-par value shares permissible for all classes
Nevada	(1) No restrictions as to amount (2) Any number	Par value of any amount. Non par shares permissible for all classes
Maryland	(1) No restrictions as to amount (2) Any number	Par value of any amount. Non-par value shares permissible for all classes
New Jersey	(1) Minimum $2,000 Maximum unlimited (2) Any number	Par value of any amount Non-par value shares permissible for all classes
New York	(1) No restrictions as to amount (2) Any number	Par value of any amount. Non-par value shares permissible for all classes
Illinois	(1) No restrictions as to amount (2) Any number, but each class is entitled to vote	Par value of any amount Non-par value shares permissible for all classes
Massachusetts	(1) Minimum, $1,000 when par value shares are authorized and minimum of 10 shares when no par value shares authorized No maximum (2) Any number	Par value minimum of $5, no maximum No par shares permissible for all classes

other things being equal, a corporation should incorporate in the State where it is to carry on its principal business

In order to give some idea of the variability of the statutes and to help readers decide on the most essential points, a table is reproduced on pages 82–89, covering these points as they are affected by the statutes of the States in which at the present time most corporations are organized. The first four columns

STOCK

15. COMMENCEMENT OF BUSINESS		16 PAYMENT OF CAPITAL	
a MINIMUM TO BE SUBSCRIBED	b MINIMUM TO BE PAID IN	a WHEN	b HOW
No requirements	$1,000	As provided for in the contract of subscription, or in absence of any provision, as called for or assessed by the directors	Money paid, labor done, or personal property, or real estate or leases thereof actually acquired
$500, at least 5 shares	$500	At such times as the directors may require	For money, labor done, or money or property actually received
No provision	No provision	As provided for in the contract of subscription, or in absence of any provision, as called for or assessed by the directors	In cash, labor, services, or personal property, or real estate, or leases thereof
No requirements	No requirements	As provided for in the contract of subscription, or in absence of any provision, as called for or assessed by the directors	For any consideration other than personal services to be rendered in the future. For the par value stock it is not necessary that the consideration for which stock is issued be equal in value to the par value of stock if done pursuant to sections [illegible] Article [illegible] Md Cod
$1,000	$1,000	As provided for in the contract of subscription, or in absence of any provision, as called for or assessed by the directors	Generally only for money or property
No requirements	No requirements	As provided for in the contract of subscription, or in absence of any provision, as called for or assessed by the directors	In money, property, or labor done
$1,000	$1,000	As provided for in the contract of subscription, or in absence of any provision, as called for or assessed by the directors	In money, labor, property (tangible or intangible, except promissory notes) or services actually performed
No provision	No requirements	As called for or assessed by the directors pursuant to provisions of by laws or in absence thereof by notice provided by statute	For cash, for property, tangible and intangible, and for services or expenses

of the table show the burden of taxation in the principal incorporating States.[7]

Taxation, it should be remembered, includes all these taxes: the original organization tax; the annual franchise tax; the stock transfer tax, which now exists in Florida, Indiana,

[7] See the Prentice-Hall State and Local Tax Service for current information on State taxes

CORPORATE OFFICES

State	17 Principal Office	18 Books and Records to be Kept at Principal Office	19 Resident Agent
Delaware	Within the State	Duplicate stock ledger	To be designated in charter
Pennsylvania	A registered office which may but need not be the same as its principal place of business must be maintained in the state	At registered office—the original or duplicate record of proceedings at directors and stockholders meetings original or copy of by laws at registered office or at office of transfer agent or registrar in state—the original or duplicate stock ledgers at registered office or principal place of business—appropriate complete and accurate books or records of account	No requirements
Nevada	Within the State	Original or duplicate stock ledger and certified copies of certificate of incorporation and by laws	Every corporation shall designate an individual or corporation to act as its resident agent
Maryland	Within the State	Original or duplicate stock ledger, unless by laws provide in other office in city of principal office and the original or a certified copy of the by laws	To be designated in charter Must be a citizen of the State, actually residing therein, or a corporation of this State
New Jersey	Within the State	Stock ledger and transfer book	To be designated in charter Must be a domestic trust corporation or resident natural person
New York	Within the State	Stock books and books of account	Must designate Sec of State for service of process
Illinois	Within the State	Must keep record of its shareholders at principal place of business or registered office or at office of registrar or transfer agent in the state	To be designated in articles of incorporation
Massachusetts	Within the State	Agreement of Association attested copy of articles of organization and amendments thereto of the by laws and amendments thereto and record of all stockholders meetings The stock and transfer books shall be kept at an office in the State but not necessarily at the principal office.	No resident agent required, but office of clerk of corporation must be filled by a resident.

New York, Massachusetts, Pennsylvania, and South Carolina; the ordinary property taxes; and occupation taxes. Inheritance taxes appear to have lost their importance as a factor in the selection of a State of incorporation. This is due to the fact that early in 1932 the Supreme Court of the United States decided in First National Bank of Boston, Executor of Estate of Edward H. Haskell v. State of Maine, 52 S Ct. 174, 284 U. S. 312, that shares of stock are taxable upon

EXECUTION OF CERTIFICATE

20 BRANCH OFFICES	21 ACKNOWLEDGMENTS	22 WITH WHOM FILED
As by laws provide	Before a Notary Public Notarial seal should be affixed If not affixed authentication of signature required	Secretary of State also recorded with County Recorder of the county where principal office is located
As by laws provide.	Before any officer within or without the state, authorized to take acknowledgments If taken without the State, authentication of signature required	Incorporators deliver articles of incorporation and proof of advertisement to department of state If articles conform to law department of state approves and files them upon payment of the required fees No provision as to recording
As charter or by laws provide	Before any person competent to take acknowledgments of deeds	Secretary of State also clerk of the county where principal office is located
If provided for in charter, by laws or by resolution of Board of Directors	Before a Notary Public or other officer authorized to take acknowledgments of deeds	State Tax Commission, which will transmit a certified copy to the Clerk of the Superior Court of Baltimore City or of the Circuit Court of the county where the principal office is located
No restriction	Within New Jersey before any officer competent to take acknowledgments of deeds Outside of New Jersey, before a Foreign Commissioner of Deeds for New Jersey, or a Notary Public with County Clerk's authentication	County Clerk of county where principal office is located also Secretary of State
As by laws provide	Before a Notary Public or officer authorized to take acknowledgments of deeds If before a Notary Public outside New York signature must be authenticated by official from whom commission was received	Secretary of State who will make, certify and transmit copy to county clerk of county where principal office is located for filing
No restriction	Before a Notary Public or other officer authorized to take acknowledgments of deeds Notarial seal should be affixed	Secretary of State and with Recorder of Deeds of county where registered office is located
No statutory provision	Directors make, sign and make oath to articles	Articles of organization, the agreement of association, and the record of the first meeting of the incorporators [illegible] the by-laws are submitted to the Commissioner of Corporations and Taxation for approval When approved the articles are filed with the Secretary of State

transfer at the death of the owner only by the State in which the owner was a resident at the time of his death. In 1939, the Supreme Court qualified the Haskell decision in Curry v. McCanless, 59 S.Ct 900, —— U S. ——, by holding that intangibles may be taxed by more than one State—that is, by the State of residence of the decedent and the State where the intangibles have acquired a "tax situs." It is uncertain how far this new rule may eventually be carried.

Example of incorporation in New York.—Suppose Joseph Hall, James McKeon, and Andrew J. Cook wish to form a company in New York with a capital stock of $100,000, for the purpose of manufacturing and dealing in certain automobile accessories.

First they would draw up a certificate of incorporation under the so-called Stock Corporation Law[8] of the State of New York. In its simplest form, this certificate would read as follows.[8a]

CERTIFICATE OF INCORPORATION
OF THE
HAMILTON AUTOMOBILE CO, INC

(Pursuant to Article Two of the Stock Corporation Law)

We, the undersigned, for the purpose of forming a corporation pursuant to Article two of the Stock Corporation Law of the State of New York, certify.

First The name of the proposed corporation shall be Hamilton Automobile Co, Inc

Second The purposes for which it is to be formed are to make and deal in automobiles, automobile accessories and supplies, and supplies for whatever purpose used (Note usually this clause is expressed at greater length and the corporation is given a wider range of "express" powers)[9]

Third: The amount of the capital stock of the corporation shall be $100,000

Fourth: The capital stock shall consist of 1,000 shares of a par value of $100 each, all of which are to be of the same class [10]

Fifth The principal office of the corporation shall be located in the borough of Manhattan, City, County, and State of New York

Sixth The duration of the corporation shall be perpetual.

Seventh The number of directors shall be not less than three nor more than seven

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[8] On October 1, 1923, a new corporation statute went into effect in New York Prior to that date corporations were organized under the Business Corporation Law, which now is practically abolished, its important provisions having been incorporated into the Stock Corporation Law.

[8a] See footnote 12 on page 92

[9] See, for example, the purposes of the United States Steel Corporation, C W. Gerstenberg, "Materials of Corporation Finance," pages 59–61

[10] If the stock is to be divided into various classes, this paragraph will contain the descriptions of the classes For examples see C. W. Gerstenberg, "Materials of Corporation Finance," page 61, United States Steel Corporation; page 57, Atchison, Topeka and Santa Fé Ry., page 101, California Petroleum Corp; page 105, Chicago, Milwaukee and St. Paul; page 107, May Department Stores For certificate of incorporation of company with shares of stock without par value, see *ibid.*, pages 43–46

Eighth The names and post-office addresses of the directors until the first annual meeting of the stockholders are

Name	*Post-office address*
Joseph Hall	98 South Elm Ave , Brooklyn, New York City
James McKeon	108 North Oak Ave , Bronx, New York City
Andrew J Cook	118 West Poplar Rd , Queens, New York City

Ninth The names and post-office addresses of the subscribers to the certificate, and a statement of the number of shares of stock which each agrees to take in the corporation, are as follows

Subscriber	*Post-office address*	*Shares*
Joseph Hall	98 South Elm Ave , Brooklyn, New York City	50
James McKeon	108 North Oak Ave , Bronx, New York City	2
Andrew J Cook	118 West Poplar Road, Queens, New York City	2

Tenth All the subscribers to this certificate are of full age, at least two-thirds of them are citizens of the United States, at least one of them is a resident of the State of New York, and at least one of the persons named as a director is a citizen of the United States and a resident of the State of New York

In witness whereof we have made, signed, and acknowledged this certificate on the 9th day of November, 1931, in triplicate

(Signed) JOSEPH HALL
JAMES MCKEON
ANDREW J COOK

This certificate is then acknowledged before a notary and the original is sent to the Secretary of State at Albany, N. Y., with the required fees of his office, amounting to $40, and a check to cover the organization tax, which in New York is fifty cents per $1000 of authorized capitalization. In this case the tax would be $50. If the Secretary of State finds no flaw in the certificate, such, for example, as a clause enabling the company to do things which an ordinary business corporation is not supposed to do—railroading, banking, insurance, etc.—and if the fees are properly paid, he will file the certificate and notify the person who sent it. He will also make, certify, and transmit a copy to the clerk of the county where the corporation is to have its principal office. The corporation is really in existence immediately upon the filing of the certificate of incorporation in the Department of State, though its existence must be begun by holding an incorporators' and a directors' meeting.[11] At these meetings various

[11] If the corporation wishes to have a certified copy of the certificate of incorporation for its own files, it will forward a copy along with the origi-

details are arranged, such as the acquiring of property and the authorization of the issuance of stock, the adoption of by-laws, and the adoption of a certificate of stock and of a corporate seal. These things are done at the incorporators' meeting At the directors' meeting the officers are elected and arrangements are made for opening the bank account.[12]

By-laws.—The certificate of incorporation of a company, together with the corporation laws governing its existence, are the corporation's charter. Since these documents are accessible to the public, everybody who deals with the corporation is assumed to have notice of their contents and will be bound by them. Since the certificate is not as easily amended as the by-laws, the former often contains matters governing the internal arrangements of the corporation which it is desired shall be quite stable. Such provisions include methods of voting, methods of making contracts, and like subjects.[13]

But ordinary matters of internal management are placed in the by-laws, which contain the rules binding on directors and stockholders. We cannot afford the space to give a set of by-laws in full, but a reasonable understanding of the way in which corporations conduct their internal management will not be had unless we give a digest of a short form of by-laws.[14]

The by-laws frequently repeat provisions contained in the certificate of incorporation, though this repetition is unnecessary. If a conflict should appear between the two documents, the certificate would govern. Of course mistakes may be corrected if the corrections do not prejudice the interests of innocent stockholders.

One of the subjects often duplicated is the rights of stockholders, especially with regard to dividends. Indeed, these provisions of the contract between the corporation and the stockholder are usually repeated even in a third place, the certificates of stock which the stockholders have as evidence

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nal to the Secretary of State, and will request that the copy be certified and returned This certified copy may then be regarded as the official certificate in possession of the company

[12] The certificate of incorporation given above was drawn to fit into a set of minutes of incorporators' and directors' meetings that will be found in C W Gerstenberg, "Materials of Corporation Finance," page 80 *et seq*

[13] See, for example, the certificate of incorporation of the United States Steel Corporation, C W. Gerstenberg, "Materials of Corporation Finance," page 62 *et seq*

[14] See the by-laws of the United States Steel Corporation, C W. Gerstenberg, "Materials of Corporation Finance," pages 66–79.

of their ownership. These provisions we shall take up later The by-laws also usually contain rules governing the issue and transfer of stock, or empower the directors to make such rules [15] The by-laws set the time and place of the annual meeting, provide for methods of calling special meetings, and stipulate the number necessary to be present to constitute a quorum. The same provisions are made for the directors' meetings. If there are any standing committees, these are provided for The one committee of this kind usually found in large corporations is the executive committee, sometimes, as in the case of the United States Steel Corporation, called the finance committee. Its duty is usually to act in the interims between directors' meetings, making decisions on such problems as may need prompt action

The whole subject of dividends and finance is covered in the by-laws. In small companies the most important provisions are those that permit the directors to choose a bank for the deposit of funds, and empower the proper officers, usually the president and the treasurer, to sign checks, drafts, and contracts. In a few States, as in New Mexico, for example, the statutes provide that all profits must be divided annually unless the certificate of incorporation, the by-laws, or a resolution of the stockholders gives power to the directors to reserve necessary amounts for working capital Where such statutes exist, the by-laws will make the necessary provisions. The effect of a provision giving the directors the right to reserve profits for working capital is to place in the hands of the directors the right to determine the amount of dividends that from time to time shall be distributed

Directors.—As shown in the certificate of incorporation on page 90, the charter usually indicates the number of directors. The number may not be less than the minimum required by law and may be changed at any time within the statutory limits. The corporate powers are exercised, the corporate business conducted, and the corporate property controlled by the board of directors. A discussion of the position of the board of directors in relation to management of the corporation is reserved for the next chapter.[16]

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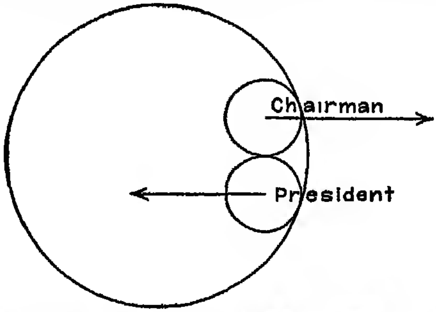
[15] For a set of rules governing the transfer of stock, see Prentice-Hall Stock Transfer Service

[16] The shortcomings of directorates as at present constituted in American corporate practice are numerous The most serious are (1) Many directors are

Officers.—The by-laws name the official positions in the company and give the powers of the incumbents. These we may list briefly:

The *chairman of the board* is usually a man of advanced years who has passed the age when he can carry details and



Relative Lines of Activity of Chairman and President of Corporation
Large circle represents the corporation President supervises internal management; Chairman, policies involving outside relations

manage day-to-day operations. He is the Nestor of the company. His advice is needed in questions of policy and in matters of great importance. His position corresponds to that of senior partner of a firm.

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inactive because they are members of too many boards One prominent financier was known to have had over 50 directorships simultaneously (2) Directors are frequently "yes" men to superior officers who are also directors (3) "Outside" directors, who spend little time with the company, take the "inside" or management directors' word for everything that comes up (4) Many boards are dominated by one director who represents a powerful financial interest (5) The fee for attending directors' meetings, which is all the compensation usually paid to directors who are not officers, is out of proportion with the responsibility placed by law upon directors The interests of stockholders cannot be adequately served by a board of directors some of whose members have, for any of the reasons noted, abdicated their responsibility Recommendations to improve the situation were made by William O Douglas, former Chairman of the Securities and Exchange Commission, in an address delivered in 1939 He suggested the following: (1) Corporations should place upon their boards working directors whose compensation is adequate and whose responsibilities are commensurate with their trust (2) Boards of directors should be smaller. (3) Professionally trained directors, who will give their full time to directing the affairs of the corporation should be added to corporate directorates

The imposition of heavy penalties under the Securities Act of 1933 against directors who participate in any offering of securities, for certain misstatements of fact and omissions (see page 358) has tended to improve the directorate situation A number of corporations have reduced the membership of their boards, many directors have resigned from boards on which they were inactive; and an increasing number of boards are made up exclusively of staff executives.

The *president* is the managing director—a position, by the way, that is recognized under that title in French companies (*administrateur délégué*). The diagram on page 94 illustrates the relative positions of the chairman and of the president.

These relative positions are further illustrated in the United States Steel Corporation, where Edward R. Stettinius, Jr is chairman and Benjamin F Fairless is president. Mr Stettinius, a comparatively young man, has had varied experience in industrial and public relations. Mr. Fairless began his career as a civil engineer for a steel company and understands thoroughly all the operations of a steel plant.

The *vice-president* in a small corporation holds the time-honored position of one standing ready to take the place of the president. In large corporations the vice-president is usually a department head, there may therefore be as many vice-presidents as there are departments.[17]

The *treasurer* has charge of the funds. In small corporations he has charge of all the ordinary financial operations, though frequently, because he has the power to sign checks, his position is comparable to that of a partner. The treasurer usually is in charge of the department of credits and collections. His assistant will then be called credit manager, or assistant treasurer in charge of credits. In large corporations the treasurer has charge of the distinct funds, such as the sinking funds pertaining to the bond issues.[18]

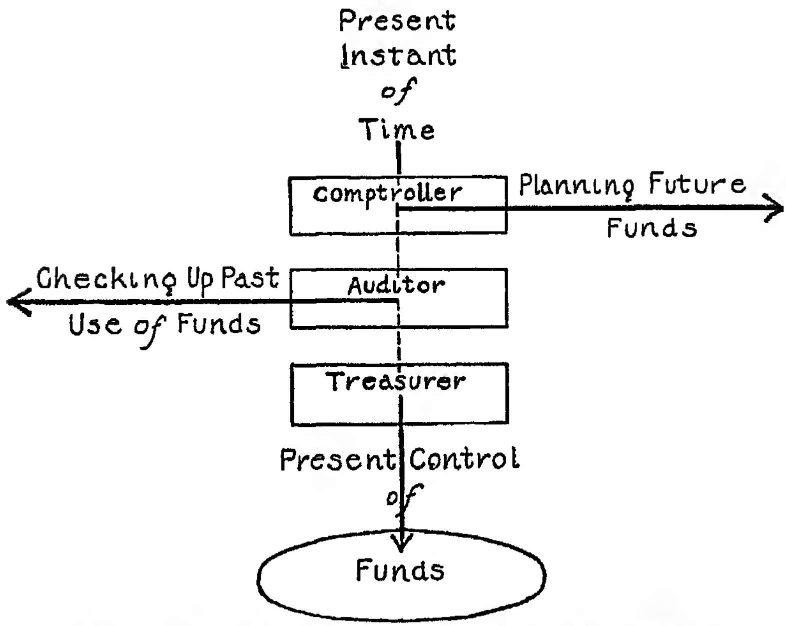
The *comptroller*, an officer known only in large corporations, is the one who does the financial planning Frequently, he is more important than the treasurer, for the latter, while he has great responsibilities in taking care of funds, merely follows such directions as are contained in the important agreements made by the corporation, such as agreements in a mortgage setting up a sinking fund, whereas the comptroller

[17] Some corporations have many vice-presidents, the theory being that nominal responsibility will induce acceptance of real responsibility An interesting story is told to illustrate the point Two men, strangers to each other, met at a golf club and challenged each other to a match As they strolled along, they got into a discussion of certain financial matters and one disputed the accuracy of a statement made by the other, adding, "I ought to know, I'm vice-president of the Blank Trust Company" "That doesn't prove anything," said the other "I'm a vice-president in the Blank Trust Company myself"

[18] While the actual funds are controlled by the trustee named in the mortgage securing the bonds, it is usually the treasurer's responsibility to see that payments are made into these funds as required by the mortgage

actually negotiates and plans, subject, of course, to the superior authority of the directors.

The *auditor* goes over the accounts to see if the funds have been properly handled and to report to the directors on the financial position of the company. The relative positions of the auditor, treasurer, and comptroller are illustrated in the diagram below.



Relative Lines of Activity of Comptroller, Auditor, and Treasurer

The *secretary*, as his name indicates, is charged with keeping the minutes of the company and with attending to all matters pertaining to meetings of stockholders and directors He has charge of certificate books and all important books, records, and documents pertaining to the company's affairs He is usually custodian of the corporate seal. In some large companies, since he has charge of the important documents, including the leases of property, one of his important duties is to act as superintendent of buildings In England the office of secretary is much more important than it is here In this country, apparently, much of the management of the company, in its strictly corporate affairs, is left to a lawyer or

to a professional accountant, whereas in England most matters of that kind are managed by the secretary

Corporations frequently have assistant officers who sometimes are brought together in council meetings to confer on matters of detail affecting the general routine of the business It is customary in such corporations to call these councils "junior officers' meetings"

The diagram on page 98 shows the organization of the financial department of a very large corporation in the United States The following data, supplied by the corporation to accompany the chart, show the exact functions of the several officers

(A-12) *Treasurer*—To have charge of accounts, custody of funds and securities, and to exercise certain rights of signature For full details of functions see by-laws of the company

(L-1) *Secretary*—To be confidential secretary to the Treasurer

(L-2) *General Statistician*—To be Chairman of the General Statistical Committee made up of the representatives of the Treasurer's, Accounting, Sales, Service, and Purchasing Departments, and to act in an advisory capacity to the Forecasts and Analysis Divisions and Cost Divisions of all departments of the Company in connection with internal statistics, with the idea of bringing about complete co-operation and co-ordination of statistical work

(L-3) *Economic Statistician*—To be special assistant to the Treasurer in collecting and presenting statistics relating to external economic and other conditions

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(L-4) *Special Duties*—The duties under the jurisdiction of the three Assistant Treasurers have to do with certain rights of signature and the custody of mortgages, agreements, bills receivable, and of postage and revenue stamps

(L-5) *Assistant Treasurer*—To exercise certain rights of signature in connection with checks, stock certificates, etc, and to be custodian of mortgages, agreements, bills receivable, and of postage and revenue stamps

(L-6) *Assistant Treasurer*—To exercise certain rights of signature on checks, stock certificates, etc

(L-7) *Assistant Treasurer*—To exercise certain rights of signature on checks, stock certificates, etc.

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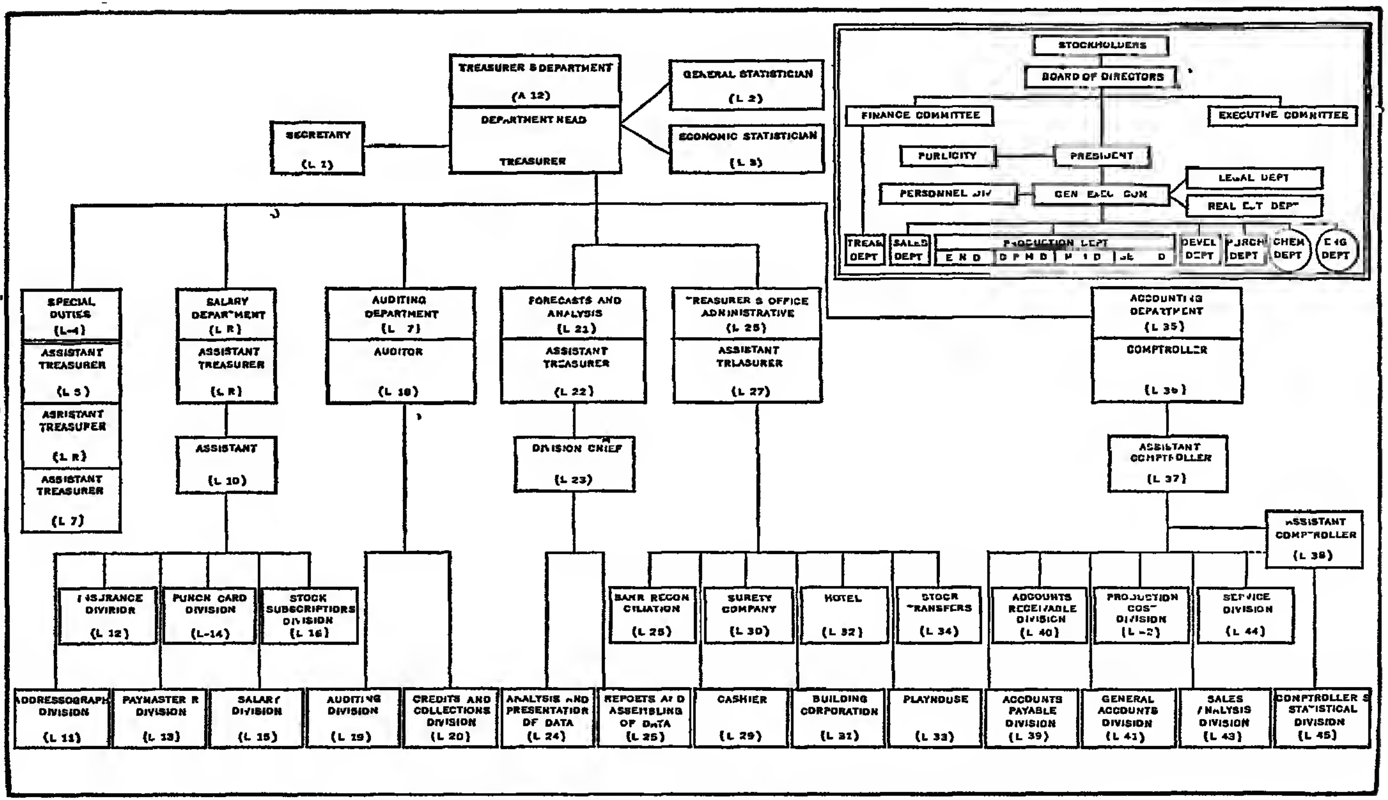
(L-8) *Salary Department*—To have jurisdiction over all work incident to the payment of salaries and wages of employees, stock subscriptions, group insurance, the custody of securities and the preparation of information regarding employees

(L-9) *Assistant Treasurer*—To have charge of all the activities of the department and its personnel, including the Personnel Committee matters,



Organization of Finance Department of a Large Industrial Corporation

to exercise certain rights of signature and approval, and to be Bonus Trustee and Custodian of Securities

(*L-10*) *Assistant*—To act as general assistant to the Assistant Treasurer in all the details of the Department's activities, to act in charge of the Department in the absence of the Assistant Treasurer, and to exercise certain rights of signature and approval

(*L-11*) *Addressograph Division*—To perform all addressograph work in connection with salaries, wages, stock subscriptions, bonus lists, securities, stockholders' lists, dividend lists and checks, and cards and lists for the Personnel Division

(*L-12*) *Insurance Division*—To be responsible for all the details of the Group Insurance Plan, calculate the amount of premiums, and advise the Insurance Company of changes in personnel

(*L-13*) *Paymaster's Division*—To check all pay rolls, prepare wage checks and wage envelopes, perform necessary wage accounting, maintain files of pay roll employees, make all payments of wages, and handle all records of unclaimed wages

(*L-14*) *Punch Card Division*—To maintain Powers punch cards on all salaried and pay roll employees for the purpose of preparing statistical information regarding employees for use in connection with the Pension Plan and the requirements of the different departments

(*L-15*) *Salary Division*—To have custody of all salary records, pay all salaries, and distribute salary charges.

(*L-16*) *Stock Subscription Division*—To have charge of the details of the Employees' Stock Subscription Plan.

(*L-17*) *Auditing Department*—To be responsible for all audits, insurance bonding, the extension of credits, and the collection of all accounts for the Company and all of its subsidiaries

(*L-18*) *Auditor*—To have charge of all activities of the Department (the details of the work are handled through two assistants), to exercise certain rights of signature on checks and vouchers.

(*L-19*) *Auditing Division*—To make all audits at the Home and Branch Offices, plants, and storage points for the company and its subsidiaries

(*L-20*) *Credits and Collections Section*—To have charge of the extension of all credits and the collection of all accounts for the company and its subsidiaries The Manager of this Section has charge of the Personnel Committee matters for the Department; to take charge of the Department in the absence of the Auditor, and to exercise certain rights of signature on vouchers.

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(*L-21*) *Forecasts and Analysis*—To be responsible for the personnel expenses and equipment of the Department, and to direct its operation, consisting of forecasts, reports, and special statements to the Financial and Executive Committees, to study, analyze, and follow up conditions in connection with investment and return on investment; to exercise certain rights of signature.

(*L-22*) *Assistant Treasurer*—To have entire charge of the Department and be responsible for its personnel expenses and equipment The detailed operations are handled through a Division Chief

(*L-23*) *Division Chief*—To have charge of all the general clerical details of the Division

(*L-24*) *Analysis and Presentation of Data*—To prepare and present in diagrammatic form, for the Executive Committee series of reports, the data with regard to return on investment and the analytical reports in connection therewith, to analyze and follow up abnormal conditions brought out in Executive Committee series, and to perform the necessary drafting and be responsible for the photostating of diagrams

(*L-25*) *Reports and Assembling of Data*—To prepare for the Finance and Executive Committees forecasts, reports, and special financial statements originating in this Department, to have charge of the assembling of the data used in Executive Committee's series of diagrams showing returns on investments, which information is furnished to the Analysis and Presentation of Data Division (L-24)

(*L-26*) *Treasurer's Office Administrative*—To be responsible for the general office details of the Treasurer's Department, bank and money matters, to supervise the operation of the Building Corporation, Hotel, Playhouse, and Surety Company

(*L-27*) *Assistant Treasurer*—To be responsible for all the affairs of the Division, including the personnel and Personnel Committee matters, and to be Treasurer of the subsidiary companies and to exercise certain rights of signature

(*L-28*) *Bank Reconciliation*—To reconcile all bank accounts

(*L-29*) *Cashier*—To receive and deposit all remittances and keep the Treasurer's Department cash book

(*L-30*) *Surety Company*—To supervise all details in connection with Bonds, except Fidelity Bonds

(*L-31*) *Building Corporation*—To manage and operate the Building.

(*L-32*) *Hotel*—To manage and operate the Hotel

(*L-33*) *Playhouse*—To attend to all details of maintenance.

(*L-34*) *Stock Transfers*—To keep the record of stockholders and all details allied therewith, to pay dividends and assemble reports for the Directors, Executive Committee, and Finance Committee, and to supervise the Treasurer's Department files

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(*L-35*) *Accounting Department*—To keep the accounts of the company and its subsidiaries All of these accounts are handled through the Division Managers. All subsidiaries report through the Assistant Comptroller to the Comptroller To perform the service functions of operating the mailing room, telegraph and telephone offices, stationery stores, hall of records, welfare work, and the extra stenographers and messengers incident to the operation of the home office

(*L-36*) *Comptroller*—To be responsible for all the affairs of the Department, its personnel, including Personnel Committee matters, and its equipment. The details of the Department are handled through two Assistant Comptrollers

(*L-37*) *The Assistant Comptroller*—To be principal assistant to the Comptroller, and to take charge of the Department in the absence of the Comptroller

(*L-38*) *Assistant Comptroller*—To be in direct control of all statistical work of the Accounting Department, and to act in a general advisory capacity to all the divisions of the Department, and to have charge of the affairs of the Department in the absence of the Comptroller and the Assistant Comptroller

(*L-39*) *Accounts Payable Division*—To be responsible for the Accounting Department details in connection with the payment of the bills of the company and its subsidiaries

(*L-40*) *Accounts Receivable Division*—To be responsible for the Accounting Department details in connection with finished products, checking freight on shipments, orders, and home office billing, and the personal ledgers and cash receipts of the company and subsidiaries.

(*L-41*) *General Accounts Division*—To be responsible for the Accounting Department details in connection with balance sheets, profit and loss, general and private ledgers, construction and experimental fixed assets, depreciation, and accident funds for the company and subsidiaries

(*L-42*) *Production Costs Division*—To be responsible for the Accounting Department details in connection with production costs and recording raw materials and supplies for the company and subsidiaries

(*L-43*) *Sales Analysis Division*—To be responsible for the Accounting Department details in connection with sales tabulation, sales expense distribution, and price checking for the company and subsidiaries.

(*L-44*) *Service Division*—To operate the mailing room and all help incident thereto, telegraph and telephone offices, stationery stores, hall of records, welfare work, and to supply the different departments in the building extra stenographers and messengers

(*L-45*) *Statistical Division*—To be responsible for the Accounting Department details in connection with investment data, contract claims, and special accounting studies

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Chapter VII

CORPORATIONS—MANAGEMENT

How corporations are managed.—Having outlined briefly its organization, we may now proceed to give a more vivid picture of the corporation by showing how it is managed The general managers of a business are the board of directors, not acting singly, but acting as a board; the details of management are left to the officers Matters of importance are always referred to the directors, who are generally given power to prescribe duties of the officers not specifically mentioned in the by-laws. Sometimes questions are too important even for the directors and then they are referred back to the owners of the business, the stockholders Moreover, since the directors are elected periodically by the stockholders, the fundamental authority may be said to rest with the stockholders In many States the laws provide that certain matters—those which affect all the property of the company at one time, such as a sale of all the assets, lease of all the assets, consolidation with another company, increasing or decreasing the capital stock, or amendment of the certificate of incorporation—must be referred to the stockholders [1] Usually a motion in respect to one of these matters is not deemed to be carried unless it receives the support of a two-thirds or three-fourths majority.

As was pointed out in the preceding chapter, large corporations usually have an executive committee which decides important matters in the intervals between directors' meetings

By way of summary, then, we may say that the ordinary questions that arise in business are decided by the officers; more important questions are referred to the executive committee; larger questions of policy that can be reserved for more formal discussion are taken up at the directors' meetings, which usually occur once a month; still more important

[1] See C W Gerstenberg, "Materials of Corporation Finance," pages 99–100

questions are taken up at the annual meeting of stockholders or at meetings of stockholders specially called.[2]

Stockholders' right to protect company against fraudulent action.—The early history of corporation finance shows many instances of fraudulent practices by directors and officers through manipulation of the company's securities The Congressional investigation of stock exchange practices made during 1932–1934 shows that even in the twenties and early thirties directors and officers of some corporations were unscrupulously using information that came to them through their positions to aid them in their market activities.[3] This betrayal of fiduciary duties was one of the reasons for the enactment of the Federal Securities Acts The Securities Act of 1933, the Securities Exchange Act of 1934, and the Public Utility Holding Company Act of 1935 have vested in the Securities and Exchange Commission control over the issuance of and traffic in securities that makes a profitable career for the corporation manipulator very difficult today.[4]

We cannot at this place go into a discussion of the forms of manipulation.[4a] The test of integrity that should be applied to any form of action is that of good faith Are the directors (1) acting in respect to the property or the securities as they would toward their own property, (2) taking unfair advantage of the position they hold or the information they

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[2] For forms of notices of annual and special meetings of stockholders, see Doris, "Corporate Meetings, Minutes and Resolutions"

[3] For accounts of some well-known early instances of manipulation, see Adam, "Chapters of Erie", W Z Ripley, "Railroads, Finance and Organization," pages 23 *et seq* 65 *et seq*, 212 *et seq*, 233 *et seq*, 274 *et seq*, 278 *et seq*, 440 *et seq* For more recent illustrations, see manipulation of American Commercial Alcohol, Sinclair Consolidated Oil, Chase Bank, and General Asphalt Co, summarized in the report cited in footnote 4a

[4] See footnote 24, p 49, for one of the statutory checks against the use of inside information by directors and officers for personal gains Another important check is the requirement in the Securities Exchange Act of 1934 that officers and directors of any corporation whose stock is registered on a national securities exchange, and holders of more than 10 per cent of any class of registered equity security, must file reports for any month in which there has been a change in ownership A similar requirement, relating to directors and officers, is contained in the Public Utility Holding Company Act of 1935 The Securities and Exchange Commission publishes a monthly summary of security transactions and holdings on the basis of the reports filed

[4a] Many of the manipulative devices brought to light in the 1932–1934 Congressional Investigation of Stock Exchange Practices are discussed in the Report of the Committee on Banking and Currency, Report No 1455, 73d Congress, 2d Session (1934)

possess to make private gain; or (3) depriving the corporation or its stockholders of rights or assets without returning a fair compensation; or (4) diverting the assets from the purposes for which they were intended to be used by virtue of the charter agreements?

Since the stockholders elect the directors, the courts generally require that the stockholders shall remedy evils by ousting directors wherever possible But frequently the directors represent the majority stockholders and the minority is helpless at corporate meetings Where such a condition exists—a wrong that is sanctioned by the majority—the courts will intervene to compel the majority to give the minority its rights [5]

Powers of a corporation.—A corporation's powers to act may be divided into three classes: (1) those expressed in the charter; (2) those incidental to the express powers, (3) those implied from the fact that the corporation is created to transact business Thus a corporation may expressly have the power to make and deal in flying machines. Incidentally it would have the power to start a school of aviation in order to increase its sales, and, because it must carry on its business as business is generally carried on, it would be permitted impliedly to hold property, to borrow money, to execute legal instruments, and in connection therewith to have and use a corporate seal. It would be improper, however, for such a company to engage in building ships of the sea, and if it undertook such work, the stockholders might restrain it, since the new venture would involve a diversion of the stockholders' investments.[6]

Voting in a corporation.—Every owner of capital stock has a right to vote his stock at all meetings of the stockholders

[5] See W M Fletcher, "Cyclopedia of the Law of Private Corporations," Vol 13, §5829 *et seq*

[6] Acts beyond the power of a corporation are called *ultra vires* acts The State which created the corporation may take cognizance of the company's breach of its contract by dissolving the company We say "breach of contract" and mean thereby the contract which the corporation has with the State to be permitted to exist as an artificial person and to do certain things as such person The laws as to the enforcibility of *ultra vires* contracts by the persons concerned are not uniform, but in general they are to the effect that such a contract entirely performed will not be set aside by the courts and one wholly unperformed will not be enforced by the courts Where it is performed on one side only, the courts are not in agreement as to the method of treatment See W M Fletcher, "Cyclopedia of the Law of Private Corporations," Vol 7, §3467 *et seq*

as an incident to the ownership of the shares, unless the right is denied by some specific contract limiting or abridging this right, such as a provision in the certificate of incorporation or in the agreement under which he holds the stock. Since the directors are agents of the corporation, they cannot delegate to other persons the right to vote at directors' meetings on corporate matters. Stockholders, however, are usually given the right to vote in person or through an agent known as a "proxy"[6a]

While at common law the rule is that each stockholder has one vote, the statutes of the States usually provide that each stockholder shall have as many votes as the number of shares he holds[7]

Non-voting and vetoing stock.—Frequently, a certificate of incorporation will provide that a certain class of stock shall not have the right to vote at all. For example, holders of the preferred stock of the Standard Oil Co of Ohio have no voting power whatsoever. Sometimes the voting stock represents a much smaller ownership than the non-voting stock[7a] Absolute deprivation of voting power is not as usual, however, as limitation of voting power. Thus, in many corporations a class of stock which has no right to elect directors will have voting power on questions which peculiarly affect the relationship of the group to the corporation, or will be given the right to elect or assist in electing directors under certain circumstances Such stock may be called vetoing stock or stock with contingent voting power Frequently, this power to vote on certain questions is included to meet the requirements of a statute. Generally it is the preferred stock that is deprived of voting power In recent years, however, there has been a tendency to divide common shares into two classes, one denominated Class "A" common and the other, Class "B" common, and to give the voting power to one class while denying it to the other.

[6a] For explanation of voting by proxy, see page 112

[7] See C W Gerstenberg, "Materials of Corporation Finance," page 90, for form of ballot

[7a] For discussion and illustrations of the disparity between the amounts of contributions by stockholders and the degree of control acquired, see "Hearings Before a Subcommittee of the Committee on Judiciary," U S Senate, 75th Congress, 3d Session (1938) on S 10 and S 3072 (Federal Licensing of Corporations), p 422

Under Chapter X of the Bankruptcy Act, which provides for corporate reorganizations, the issuance of non-voting stock by the reorganized corporation is prohibited

Questions upon which non-voting stock is frequently given right to vote.—The matters upon which stock that is non-voting will be given the right to vote usually include the following:

1. Authorization of an increase in the issue of preferred stock. If a corporation has no bonds outstanding, its preferred stock will have the first claim on its earnings. If there is to be any new financing, the common shareholders will not care whether the preferred stock is increased or a new class of second preferred is created. But to the old preferred stockholders the difference is of great importance. Carefully drawn charters, therefore, usually provide that special consent of the preferred stockholders must be obtained to increase the preferred stock.

2. The authorization of an issue that will have a claim on the earnings or property of the corporation prior to that of the particular issue involved.

3. The making of mortgages or liens. Purchase money mortgages are often specifically excepted.

4. The issuance of bonds, notes, or other evidences of debt

5. The sale of the corporate assets, merger, or consolidation.

6. Other subjects upon which non-voting stock may have the right to vote include a change in the by-laws of the corporation; a change in the preferences, privileges, or other characteristics of the stock, such as a change in its par value, a change in the voting power; dissolution, a change in the purposes of the corporation; guaranties

Variations in the arrangements for contingent voting power are limitless. No one issue is likely to include provision for voting under all the contingencies enumerated, but numerous examples can be found to illustrate each.

Voting rights contingent upon defaults.—Frequently, while the preferred stock will not have the right to vote under ordinary circumstances, that right will operate when dividends on the preferred are passed for a specified number of financial periods. For example, none of the many classes of preferred stock outstanding of the Associated Gas & Electric

Co. has voting power unless dividends are in arrears for two years on the particular class of stock. In some instances, the right to vote is given if earnings fall below a certain level. Giving non-voting stockholders the right to vote in case dividends are passed is based upon the theory that the holders of non-voting stock are entitled to voting power in order to protect their dividend rate.

Other contingencies have been made the basis for giving non-voting stockholders voting power. Thus the right to vote may be given if the corporation fails to maintain net assets, net tangible assets, or net quick assets up to a prescribed standard. Similarly, non-voting preferred stock may become voting upon failure of the corporation to redeem preferred stock, or to make sinking fund payments.

Great variety is found in the extent to which the non-voting stock becomes voting upon the occurrence of the defaults. In many instances the non-voting stock obtains exclusive power to vote for directors until the default is corrected; in others, the non-voting stock acquires equal voting power with the regular voting stock, and in some cases extra voting power is given. For example, the Sherwin Williams Co. 6 per cent cumulative preferred stock is entitled to full voting power in the ratio of four votes per share to one vote per share of common during the time that the company is in default in payment of four quarterly dividends, or in the maintenance of net assets, or in sinking fund payments. Another arrangement permits the preferred stockholders to elect a majority or a certain number of the directors during the period of default.

Non-voting stock criticized.—Corporation stock issues of recent years show a decided tendency toward concentration of control and restriction of voting rights to certain classes of shareholders. The tendency is inspired by the desire of the organizers to control the corporation with a comparatively small amount of invested capital If the organizers hold all the voting stock, they can finance the corporation through the sale of unlimited amounts of non-voting stock without losing control.

When the trend toward classification in voting rights reached the place where part of the common stocks as well as all the preferred stocks were being deprived of voting power,

it became the object of much criticism.[8] The principal objection raised against non-voting issues is that stockholders who should have the right to object to the manner in which the management is conducting the business can do nothing about replacing the inefficient managers. While dividends are being paid, stockholders are likely to give little attention to the management of the corporation, but when dividends fail they are no longer indifferent and are likely to take a lively interest in the affairs of the corporation. If they have no voting power, their interest is ineffective. Even the right to vote in case of default in payment of dividends may prove ineffective if there is a preponderance of voting common stock.

The Public Utility Holding Company Act of 1935 seeks to curb the abuses that resulted from the issuance, especially during the twenties, of stock without voting rights or with restricted voting rights. The Act gives the Securities and Exchange Commission considerable power to see that the corporate structure of subject companies does not unfairly or inequitably distribute voting power. The amended Bankruptcy Act also seeks to avoid abusive concentration of control through voting restrictions by requiring that the plan of reorganization must provide for equitable distribution of voting power. Non-voting stock is prohibited in the reorganized company, and preferred stockholders must be given the protection of adequate provision for election of directors by them in the event of default in the payment of dividends.

As a result of the criticism, the New York Stock Exchange adopted a resolution which simply stated that the stock listing committee "in considering applications for the listing of securities, will give careful thought to the matter of voting control." The effect of the policy of the New York Stock Exchange was to check the number of non-voting issues. The Stock Exchange seems to object to non-voting stock when it is applied to common shares but to sanction the practice when it is applied to preferred stock, if provision is made for voting power in the event of defaults in the payment of dividends.

Restrictions on amount of stock outstanding.—Somewhat similar to the question of voting restrictions is that of restrictions on the amount of stock that may be issued. In many

[8] See article of William Z Ripley, *Proceedings of the Academy of Political Science*, January, 1926, and *Atlantic Monthly*, January, 1926 See also article by W. H S. Stevens in the *Quarterly Journal of Economics*, May, 1926, entitled "Stockholders' Voting Powers and the Centralization of Voting Control"

States the maximum amount of stock which a company may issue is not directly limited. And in most corporations the directors are not limited in the amount of stock they may issue, except by such well-known rules as, for example, that the stock must be issued for value and that it must first be offered to the old stockholders.[9] But in some modern corporations restrictions similar to those placed in deeds of trust on the issue of bonds are inserted in the charter. The charter of Colgate-Palmolive Peet Co. provides that additional preferred stock cannot be issued unless: (1) the average annual net earnings for the three years preceding such issue shall amount to not less than three times the annual preferred dividend requirements after the proposed issue is made, and (2) unless the net current assets as defined in the charter shall equal the par value of the preferred stock outstanding after the proposed issue is made. The charter of Montgomery Ward & Company, Inc., at one time provided that additional preferred stock might be issued at not less than $100 per share, but only when for two fiscal years preceding such issue, the average net earnings equalled the sinking fund requirements plus two and one-half times the amount of the preferred dividend requirements after the proposed issue was made, and when the net quick assets at least equaled 120 per cent of the par value of the preferred stock outstanding after the proposed issue was made.[10]

Cumulative voting.—Complaints have frequently arisen that majority stockholders oppress the minority. Under the old-fashioned rule of voting, which still prevails in many corporations, the stockholder is entitled to cast a number of votes equal to the number of shares he holds for one candidate for each position on the board of directors. Where, for example, five directors are to be elected, a person holding fifty-one shares out of one hundred shares of stock can elect his five candidates. To obviate this difficulty, a system of cumulative voting has been devised which in some States is prescribed by the statutes or the constitution of the State, and in other States is often included as a part of the machinery of management provided in the certificate of incorporation. Under this system of voting each stockholder has as many

[9] See Chapter XX.

[10] See "Prentice-Hall Encyclopedia of Corporate Forms," Vol. I, Forms 1575, *et seq.*, for clauses in certificates of incorporation showing usual restrictions upon issuance of stock.

votes as is equal to the number of voting shares he owns multiplied by the number of directors to be elected. These votes he may accumulate for one candidate or may distribute among the candidates for election in any way he sees fit. In the example cited above, the majority stockholder would have 255 votes and the minority interests would control 245 votes. If the majority sought to elect five directors, they would give each candidate 51 votes. The minority interests could strategically divide their 245 votes among three candidates, giving two 82 votes, and the third 81 votes. These three candidates would be declared elected and the remaining two positions would be declared vacant on the tie vote of 51 ballots for each of five candidates.[11]

Other methods of voting.—The original common law rule was one vote for each shareholder. When this rule was modified by corporate charters and by statute, giving every shareholder as many votes as the number of shares held by him, difficulties were often experienced by promoters in interesting the small subscriber In order to avoid this objection, the plan was introduced of giving one vote for each share up to a certain number of shares and then one vote for a group of shares beyond that number, with possibly a maximum number of votes for each shareholder. Thus the stockholder might have 10 votes for the first 10 shares, one vote for each 10 shares thereafter until a maximum of 100 votes was reached, whereupon voting rights in respect to shares ceased. Any contract of that kind can usually be made in the certificate of incorporation. It has been held in England that arrangements of this kind can be avoided by transfer of shares to another person, whereas in America the rule has generally been that the attempts to defeat contracts in this way are illegal.[12]

Who is entitled to vote?—The right of a stockholder to vote rests on the corporate records. Therefore, only *stockholders of record* possess that right; and in case of a dispute between two persons attempting to exercise the right to vote on the same shares, the chairman of the meeting must consult

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[11] A formula has been devised for discovering the least number of shares a stockholder requires to elect a desired number of directors: x must be greater than $\frac{ac}{b+1}$ where a equals the total number of shares outstanding; c the number of directors it is desired to elect; and b the total number of directors to be elected. See "Mathematics of Cumulative Voting," by C W. Gerstenberg, *Journal of Accountancy*, January, 1910

[12] See A. W. Machen, "Modern Law of Corporations," Sec. 1217.

the stock book and be bound by the record. Of course, if it happens that for some reason one who is not the stockholder of record possesses the right to vote, that person may apply to a court of equity for a writ compelling the acceptance of his vote. But he must do so before the meeting, for at the meeting the chairman is bound to recognize the person shown to be a stockholder by the stock book, unless a court writ is served on him.

As between a trustee and his *cestui que trust* (the beneficiary), the trustee has the right to vote, for he is the stockholder of record As between pledgor and pledgee of shares, so far as the corporation is concerned the one whose name appears on the books has the right to vote. But as between the parties themselves, the result would depend on the agreement they made. In a case of a simple hypothecation, the pledgor, possessing the legal title, has the right to vote, and if the shares have been transferred by the pledgee to his own name, the pledgor may demand a proxy from him. In some States, including New York, this right of the pledgor to a proxy is guaranteed by the statute. However, unless the pledgor obtains this proxy before the meeting, the chairman of the meeting must allow the stockholder of record to vote. A corporation, of course, cannot vote on its own shares, but it can vote on shares it owns in other corporations. Where stock is held jointly by two persons, they must agree or their votes will be thrown out.[13]

Closing the stock book.—To give the secretary of the corporation time to prepare the list of stockholders of record for the chairman of the meeting, and to avoid any confusion that might result from making transfers on the books at the last minute, the by-laws of a corporation may provide for the closing of the stock transfer book for a reasonable period, usually not exceeding forty days prior to the stockholders' meeting If this provision is in the by-laws, or State statutes, the directors may fix a day for the closing of the books, after which and until after the meeting, the secretary or transfer agent will refuse to record any transfers on the stock book. In small corporations there is no real need for closing the books. Some of the larger corporations are finding that lists of stockholders can be prepared on the day of the meeting without closing the books and without any confusion. Another practice is

[13] For a complete discussion of the law, see W. M. Fletcher, "Cyclopedia of the Law of Private Corporations," Vol 5, §2025 *et seq.*

that of preparing a list as of the close of a certain day, that list by charter or by-law provision to be binding on the corporation and its stockholders. Wherever it is possible to do so, it is better not to close the books, for such a practice unduly interferes with the transfer of shares.

Voting by proxy.—A proxy is a revocable written power of attorney by which a stockholder of record transfers his right to vote without transferring the title, either legal or equitable, to his shares[14] At common law, and today usually in religious and similar corporations, a stockholder cannot vote by proxy, but must vote in person. But statutes generally permit voting by proxy Even in the absence of a statute it has been held on the ground of practical convenience that by-laws may provide for it.

During the years 1925–1930 many contests for control of corporations turned into proxy battles that showed the weaknesses of the proxy system.[15] In many cases the contest was merely moved from the meeting room to the courts. Interest in legal questions concerning proxies was stimulated by the proxy fights. These questions generally touch upon the reasonableness of the present practice of permitting stockholders of record to vote stock that is sold between the record date for determining who shall vote and the time of the meeting. Other questions that arise relate to the right of trustees, executors, and other fiduciaries to give proxies to vote stock held of record by them in their fiduciary capacities. The general principle is that a fiduciary cannot delegate his authority. Hence a trustee, executor, or administrator cannot vote by proxy unless he has specifically been given that power in the instrument creating his office, or unless the statute under which the corporation is created so provides. The fiduciary may give a proxy, however, that directs the proxy-holder in the manner of voting.

Restrictions on solicitation of proxies.—Corporations whose securities are registered as required by the Securities Exchange Act of 1934 (see page 369) must follow the rules of the Securities and Exchange Commission governing solicitation of proxies. Penalties are imposed for failure to conform. The rules require that a written "proxy statement" be

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[14] See C W Gerstenberg, "Materials of Corporation Finance," page 88, for form of proxy

[15] See article in *Barron's*, January 5, 1931, entitled "Youngstown-Bethlehem and Other Proxy Contests."

furnished to each person whose proxy is being solicited. The proxy statement must set forth (a) the identity of persons soliciting the proxy, (b) the nature of the matters to be voted on under the proxy, (c) power of the security holder to revoke his proxy and the rights of dissenting stockholders, and (d) the expenses of the solicitation, including all compensation paid to solicitors In addition, certain financial data are sometimes required to be included. The proxy must provide some definite means whereby the security holder may indicate how he desires his vote to be cast on a given proposition. Where the solicitation of proxies covers the election of directors, the proxy statement must give certain information as to each person for whom it is intended to vote The proxy statement of Columbia Gas & Electric Corporation for a special meeting of stockholders held March 7, 1939, constituted a document of twenty-six printed pages.

If the corporation solicits proxies, it must also send stockholders whose proxies are solicited any proxy form submitted by a stockholder who supplies proxies and defrays all costs.

Brokers' proxies.—Frequently, stock is registered in a broker's name and not in the name of the person for whose account it is held. Under the Securities Exchange Act of 1934, brokers may not give a proxy in respect of any security registered on a national securities exchange and carried for the account of a customer, in contravention of rules prescribed by the Securities and Exchange Commission.

Under the rules of the New York Stock Exchange a member broker must, upon request, furnish a beneficial owner with a proxy to vote the stock. Brokers must forward to each beneficial owner of stock which is in their possession or control, except owners outside the United States, the material furnished by anyone soliciting proxies, together with a request for voting instructions, provided the person soliciting the proxies reimburses the broker for expenses involved. If voting instructions are not received by the tenth day before the meeting, the broker may give a proxy to vote stock registered in its name, if he has no knowledge of any contest as to action to be taken at the meeting, and provided such action does not include authorization of a merger, consolidation, or any other matter which may affect substantially the legal rights of such stock.

How minorities often control corporations.—It is a noticeable fact in American corporation finance that large corpora-

tions are usually controlled by people who own less than 50 per cent of the stock. Indeed, the management of a large corporation is usually able to retain control with a comparatively small ownership.[16] Eight reasons for this condition we shall explain in the sections following.

1. *Indifference of stockholders.*—Only a small portion of the entire ownership of a corporation may be represented at any meeting and an organized minority will then become a majority of the active ownership. Negligence and indifference are perhaps the two chief causes why a large part of the stock of the company is unrepresented.

2. *Proxy committees.*—In American corporations the practice has grown up of electing a proxy committee at the annual meetings. The names of the members of this committee are printed on a so-called official proxy which is sent out with the notice of the ensuing annual meeting. The stockholder, therefore, has merely to sign his name to the printed form, to have his signature witnessed, and to enclose the form in a stamped and addressed envelope which is sent by the company, in order to be represented. Although a proxy may subsequently be revoked,[17] a so-called insurgent, that is, a person who is trying to organize the outsiders to defeat the management, will usually find that the stockholder is reluctant to reverse an action once taken. At meetings where there is a contest, the final vote usually shows that the management, through the proxy committee, controls the greater strength.[18]

[16] During the Alton investigation, which began at the close of 1906, E H Harriman and other witnesses admitted that to secure absolute control of a railroad, it was necessary to own or concentrate only 20 per cent of the stock During the investigations of the thirties, it was revealed that ownership of 73,000 shares of Chesapeake & Ohio Ry common stock, which represented not more than 15 per cent of all the outstanding stock, endowed the Van Sweringen interests with control of the railroad

[17] In New York State a proxy may be made for any definite time, but if the time is not specified it expires in eleven months In Delaware a proxy cannot be voted upon after three years from its date unless it provides for a longer period Frequently, the proxy is given for one meeting only, and it will then be good for that meeting and all adjournments thereof.

[18] At the annual meeting of the United States Steel Corporation in 1938, when questions of importance were to be discussed, the proxy committee represented 6,288,724 shares out of 6,327,253 shares of common stock and 2,805,943 shares of preferred stock out of 2,809,160 represented at the meeting. Stockholders representing 901 shares of common stock and 1,405 shares of preferred stock, included in the above figures, were present in person, but gave their proxies to the committee There were then outstanding a total of 8,703,252 shares of common and 3,602,811 shares of preferred.

While most often it is the management, through its proxy committee, which controls the greater strength at a meeting, there is nothing to prevent another interest from forming a proxy committee and sending out a call for proxies In fact, in the case of corporations whose securities are registered on a national securities exchange, the management may be requested to mail proxies and other communications furnished by any security owner of record to stockholders who are solicited for proxies by the management, provided the person making the request supplies envelopes and postage, and reimburses the corporation for expenses incurred in connection with such mailing. The opposition committee may succeed in getting control of the corporation through its campaign for proxies and may thus thwart the plans of the management, or even oust it.

3. *Voting and non-voting shares.*—We have already indicated that stock may be divided into different classes, and that one class may be given the sole voting power. Thus, by the purchase of common stock of Alleghany Corporation for $255,000, control was obtained over $88,000,000 of preferred stock that had no voting rights [18a] Corporations have actually been organized in which one share of stock has the right to vote, and all the other shares are deprived of that right. Founders' stock and management shares, described on page 156, are further examples of minority control through classified shares.

4. *Classified voting.*—An example of differential voting, where both classes have the right to vote but one class has an advantage over the other, was afforded by the old Rock Island Company, formed in 1902 to control the so-called Rock Island System. The holders of the preferred stock were given the right to elect five of the nine directors Ripley[19] estimates that in 1908 $5,000,000 worth of preferred stock controlled a nominal capitalization of subsidiary companies of $1,500,000,000. Sometimes the privilege of electing directors is given to one class of stock temporarily, as in the case of the Wheeling and Lake Erie, where, under the reorganization of 1917, the prior-lien stockholders, for a period of five years after incorporation, had the exclusive right to elect the majority of direc-

[18a] See Investigation of Railroads, Holding Companies, and Affiliated Companies, Part 10 (1937), p. 4071

[19] W Z. Ripley, "Railroads, Finance and Organization," page 529

tors. Very frequently this right to elect the directors is made contingent upon the happening of some event, as explained on page 106.

5. *Vetoing, or voting on special subjects* Preferred stockholders are more interested in some subjects than in others. As to these subjects they are frequently given ample control, even though the preferred stock may constitute but a small minority of all the stock issued.[20]

6. *Partial retirement of board of directors.*—Sometimes the directors are divided into classes and are elected for overlapping years, somewhat after the pattern of the United States Senate, where the term is six years and where the terms of office of one-third of the senators expire every two years. Where such a plan is used, the management is given warning of the growing strength of the minority and may use greater diligence in getting proxies at subsequent elections. For example, the certificate of incorporation of a company may provide for twelve directors, three of whom are to be elected each year. At one annual election the management may be surprised to find that a few active leaders of the minority have persuaded enough stockholders to give them their proxies to enable them to carry the election. Their success, however, would mean that they would have only three out of twelve directors. At the ensuing election the managers will undoubtedly make a more active campaign for proxies and will probably be able to secure enough to elect their candidates.

7. *An iron-clad method of minority control.*—The certificate of incorporation may provide that a large majority is necessary to elect directors and this rule will undoubtedly, in such cases, be protected by a similar provision that the certificate itself cannot be amended except by a large majority vote. Where such a rule is made and permitted by the statutes of the State, the controlling party may remain in office by defeating the elections. Thus if a seven-eighths majority were required to elect directors, the directors when in power could defeat any future election if they owned one share more than one-eighth of the outstanding shares. In such cases there would be no election and the old directors would hold over.

8. *Stock purchase warrants to retain control.*—By the advance sale of the right to become a stockholder, the cor-

[20] For a complete discussion of vetoing stock see page 105

poration may give the management assurance of remaining in control. This right is evidenced by a warrant or option, explained more fully on page 149, which gives the warrant or option holder the right to purchase stock at a fixed price. With this medium it is possible to check the loss of control. For example, those in control of a corporation may own only a small portion of a large issue of voting stock Unless they can obtain additional voting shares in sufficient amount to defeat an organized opposition, they are likely to lose control at any time In order to be in a position to purchase the shares when needed, the managers will, at the time of assuming control, be given warrants to purchase additional shares of voting stock at a fixed price The corporation always has sufficient unissued stock to meet the demands of warrant holders Should the management find at any time that outside stockholders are likely to combine to oust them, they need only exercise their warrants and purchase sufficient additional stock to assure their continuity of control.

Denial of preëmptive right to subscribe as an aid to minority control.—The tendency of corporations to issue stock to which the inherent right to subscribe to new issues does not attach may also help minorities to retain control. Thus, if the corporation is not obliged to offer new issues of securities to its old stockholders, and the management is anxious to have additional shares in order to assure control, it may authorize the issuance of additional stock and permit friendly interests to subscribe to as much of the issue as it needs to remain in control. To be sure, the corporation may have to obtain the consent of the old stockholders in case it is necessary to increase the capitalization before issuing additional stock, and the stockholders may withhold their consent if they anticipate that the management is going to use the issue to assure control. Corporations, however, frequently have an authorized issue of stock in excess of the amount outstanding and the purpose under these circumstances can be accomplished without the consent of the stockholders. For a discussion of the stockholder's right to subscribe to new issues of stock, see pages 336 *et seq.*

Voting trusts.—A method, known as a voting trust, has been devised for concentrating the control of a company in the hands of a few people. A trustee, or a group of trustees, makes a contract with the stockholders providing that any of

the stockholders of the company may deposit their stock and become parties to the agreement. Since their stock is transferred on the books of the company to the voting trustees, the latter become the real stockholders and during the period of the agreement vote at the annual elections and at special meetings. Voting trust certificates are given to the stockholders who become entitled to the dividends. The certificates are often listed on the exchanges When the trust is dissolved, the trustees exchange their stock for the certificates of beneficial interest and the stockholders thereupon become reinstated with the right of control.

Voting trusts cannot be used by a number of competing corporations to work out a monopoly. This doctrine was decided many years ago when monopolies were organized through the formation of voting trusts to take over the legal titles to the stock of the several corporations that entered the old Standard Oil trust and the old sugar trust. In fact, it was in connection with these voting trusts that the word "trust" first came to be applied to monopolies. Usually a voting trust must be limited in time, measured by the definite purpose to be accomplished. For example, if the bondholders of a corporation threaten to foreclose the mortgage securing their bonds, they may be induced to forego this right if given control of the corporation till their bonds are paid off. This can be done by creating a voting trust in which the trustees are nominated by the bondholders. In this way the bondholders would control the directorate of the company until their bonds had been paid off. In New York State, under the statutes, a voting trust cannot endure for longer than ten years.[21] Where a voting trust is created for a period beyond the statutory limit, the trust is wholly invalid.

The most common use of the voting trust is in connection with the reorganization of corporations. The period of the voting trust covers the critical time of rehabilitation, during which control of the corporation is turned over to people who can be relied upon to manage it. Continuation of their control is assured by the voting trust arrangement. Voting trusts are also used in industrial organizations as a means of securing continuity of management and policy of the com-

[21] For an example of a voting trust agreement, see C. W. Gerstenberg, "Materials of Corporation Finance," pages 91–97 See *ibid*, page 98, for illustration of certificate of beneficial interest. For a very excellent and extended discussion, see H. A. Cushing, "Voting Trusts"

pany Those who manage the corporation are the voting trustees. They may own only a small part of the whole issue. During the period of the trust agreement, with a minority of the stock they are assured of control without investing any further sums in the corporation Sometimes only part of the securities, but always sufficient to assure control, are deposited under the voting trust agreement in exchange for voting trust certificates In that case the shares not deposited would be transferred on the books of the corporation in the regular way and the voting trust certificates would be transferred on the books of the voting trustees The market price of the securities not deposited is generally the market price of the voting trust certificates, although occasionally securities not deposited sell above or below the voting trust certificates.

The voting trust arrangement assures control to the majority in cases where the latter, through failure of some of them to exercise their voting power, may not be certain of control without it. For example, if the majority holders are scattered or become inactive because of a false sense of security, a centralized minority might easily spring a surprise at a stockholders' meeting and capture control

Treatment of voting trusts under Federal acts.—Voting trust certificates are included in the definition of securities under the Securities Act of 1933 and are subject to the Act. Similarly, if the voting trust certificates or the deposited stock represented by them is listed on a national securities exchange (see page 369), they are subject to the Securities Exchange Act of 1934.

The Securities and Exchange Commission, in administering the Public Utility Holding Company Act of 1935, has sanctioned the use of voting trusts in reorganizations of companies subject to the Act, in cases where this device has appeared to be in the interest of the public, investors, and consumers. Thus, in the reorganization of Great Lakes Utilities Company, it approved the voting trust even though the device tended to complicate the corporate structure of the holding company system.

Any plan of reorganization of corporations under Chapter X of the Bankruptcy Act may provide for vesting control of the reorganized corporation in a voting trust, but the appointment of the voting trustees must be equitable, compatible with the interests of creditors and stockholders,

and consistent with public policy. The Act requires the judge to pass upon the qualifications of the voting trustees as a condition of confirmation of a plan

Control transferred to a holding company.—The same purposes sought to be achieved in a voting trust may be made more permanent through the device known as a holding company.[22] The central control afforded by the holding company device was originally used to promote and develop a single field of industry.[22a] Unfortunately, in the decade of the twenties, promoters and others perverted the use of the holding company. It became a device for developing the promotion of security-selling schemes, and for avoiding taxes The abuse of the holding company plan led to various forms of Federal legislation designed to control holding companies The Public Utility Holding Company Act of 1935, for example, controls holding companies in the electric and gas utility fields This and other legislation is discussed more fully in the chapter relating to holding companies. See Chapter XXXI.

Stockholders' rights to information.—We have seen that the fundamental control of a corporation rests in the stockholders. Their control cannot be intelligent unless they are informed of the condition of the company. Most corporations issue annual reports, some large corporations issue abbreviated quarterly reports, and a few make public month by month the results of their operations.[23] Where no information is voluntarily given, stockholders are usually given a statutory right, under restrictions that will safeguard the interests of the corporation, to demand a balance sheet at

[22] A holding company is to be distinguished from a parent company, since the former merely holds securities of subsidiaries while the latter in addition carries on its own operations (See Chapter XXXI)

[22a] An early notable example of control acquired through a holding company was the formation in 1902 of the Chicago, Rock Island and Pacific *Railroad* Company and the acquisition by it of the stock of the operating Chicago Rock Island and Pacific *Railway* Company, for which collateral trust bonds of the former company were given. The entire story is interesting and is told in W. Z. Ripley, "Railroads, Finance and Organization," pages 153–155 and pages 527, et seq An outstanding example of more recent years is the organization of the Alleghany Corporation in 1929 by the Van Sweringen interests The use of the holding company device by the Van Sweringen brothers in acquiring control of a vast network of railroads with a "shoe-string" investment is described in Report No 1455, 73d Congress, 2d Session (1934), entitled "Stock Exchange Practices."

[23] Annual reports of corporations have become more comprehensive since the economic depression that began in 1929 Some corporations adopted the practice, during the thirties, of sending annual reports to employees

least once a year. The statutes of most States provide that stockholders may inspect the records of stockholding and in that way determine who are the stockholders of a corporation to whom they can appeal for cooperative action in defeating oppressive acts of the directors. The statutes of the State in which a corporation is organized must be consulted to determine the limits of the stockholders' rights of inspection. Corporations whose securities are listed on the New York Stock Exchange or the Chicago Stock Exchange must agree with the Exchange to issue annual reports.[24]

In the absence of a statute, stockholders possess the right of inspection of the corporate books, records, and papers for proper purposes, at reasonable times and places. This right of inspection extends to such records as by-laws, the minutes of stockholders' meetings, and the stock register, it may even include the inspection of the books of account and the minutes of the directors' meetings, for the purpose of discovering fraud or mismanagement of the directors. Good cause, however, must be shown before inspection for this purpose will be granted.

All corporations having securities registered on a national securities exchange, under the Securities Exchange Act of 1934, are required to file an annual report with the exchange and with the Securities and Exchange Commission. The Commission has power to demand quarterly reports Periodical reports may also be required under the Securities Act of 1933 to keep up to date the information given in the registration statement. These reports are open to public inspection at the exchange on which the security is registered. Certain portions, which the corporation considers confidential, however, may be kept from disclosure.

Another source of information for stockholders of corporations whose securities are listed on a national securities exchange is the monthly summary of security transactions and holdings of directors, officers, and large stockholders, published by the Securities and Exchange Commission.[25] While this information does not reflect the financial condition of the corporation, it throws considerable light upon whether those in control of the corporation are making unfair use of inside information.

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[24] For excellent examples of annual reports, see C W. Gerstenberg, "Materials of Corporation Finance," pages 622–752.

[25] See footnote 4, page 103

Chapter VIII

CORPORATE STOCK

Fundamental rights of stockholders.—The fundamental rights of each stockholder may be enumerated as follows:

1. To a certificate showing his ownership of shares.
2. To transfer his ownership in his shares.
3. To inspect the books of the corporation.
4. To protect the corporation against wrongful acts of the majority.
5. To restrain *ultra vires* acts of the corporation
6. To vote for directors.
7. To vote on other questions affecting the corporation's property as a whole.
8. To receive dividends when they are declared.
9. To subscribe in proportion to his holdings for any new issue of stock.
10. To share in the proceeds of dissolution.

Of these various rights, some have been explained, such as numbers 3, 4, 5, 6, and 7, under the general subject of the management of the corporation; 8, 9, and 10 will be discussed at an appropriate time later; 1 and 2 will be discussed under the heading, methods of issuing and recording shares, page 123.

Classes of stock.—In order to modify the fundamental rights and to vary the risks of the owners of the corporation, various forms of stock have been devised. These variations concern either the amount of income or stability of income of the stockholder, his right of control, the risk he runs of the ultimate loss of his investment, the time during which he shall be a stockholder, or his right to exchange his stock for other forms of stock or other securities. The principal variations we shall take up separately.

Stock and certificates of stock.—But first we must be sure our readers understand the difference between stock and certificates of stock. Another word may be defined at the same time, namely, shares. Stock is the aggregate ownership of a corporation, and is divided into identical units, or groups of

identical units, called shares, and is represented by written instruments called certificates of stock.[1]

Certificates of stock.—Restating what was said in the last paragraph, stock is ownership. Shares are units of ownership. The evidence of these is the certificate of stock These certificates under modern statutes have been made negotiable.[2] If the owner indorses them in blank, and they are lost or stolen and get into the hands of an innocent purchaser, the latter gets good title as against the original owner.[3] When certificates are lost, it is usual to notify the transfer agent immediately. If the certificate is not recovered, the owner puts up a bond to protect the company against the claims of a subsequent innocent purchaser and the company thereupon issues a new certificate.

Methods of issuing and recording shares.—If Faith Jones pays $10,000 for 100 shares of stock of the Columbian Trading Corporation, she will receive one certificate certifying that she owns 100 shares. If, now, she wishes to sell 40 shares to John Smith, she will fill out the assignment as is indicated in the form on page 124 and will send the certificate to the transfer agent whose duty it is to make the transfer on the

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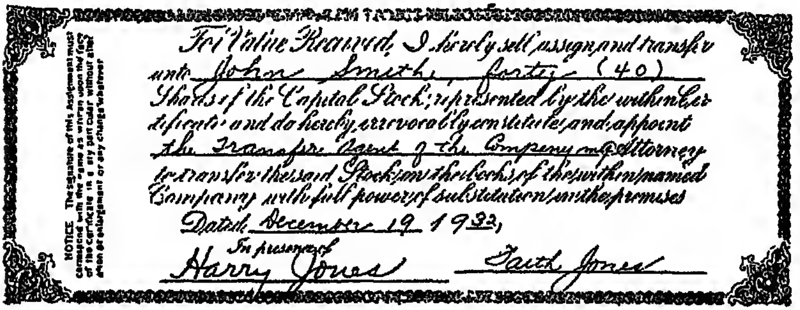
[1] In England, the unit shares may be consolidated in certain cases into stock which is then sold by the amount and not by the unit, though sometimes restrictions in the charter provide that the amounts must be multiples of a certain unit, such as a pound Dividends are paid on the amount of stock held, and the stockholder will have as many votes as are equal to the total amount of stock held divided by the par value of one share

[2] For a copy of the Uniform Stock Transfer Law, see C W Gerstenberg, "Materials of Corporation Finance," pages 111–112

[3] The title to ordinary personal property cannot be divested except by voluntary act or operation of law Since the Uniform Stock Transfer Law could not, under the Federal Constitution, be made to change contracts already existing, certificates issued in any State before such law went into effect (in New York, September 1, 1913) are, if still outstanding, non-negotiable, and the loser will not be divested of the title unless he acts voluntarily in respect thereto, or unless the stock is seized by operation of law, e g , in execution of a judgment. But if a holder of such a certificate indorses it in blank and entrusts it to another, who abuses the trust and sells it to an innocent purchaser, the latter will get title by estoppel Or if a certificate dated before the Uniform Stock Transfer Law went into effect is indorsed in blank and is lost, and the finder fills in his own name and has the certificate transferred to himself, after which he sells it to another who relies on the fact that the corporation holds out the seller as the owner, the purchaser, while not getting title to the stock as against the original owner, will get a right against the corporation for the value of the stock, on account of the false holding out contained in the certificate. See W M Fletcher, "Cyclopedia of the Law of Private Corporations," Vol. 12, §5562

books of the company.[4] In small companies the transfer agent is usually the secretary, and he does not make any special note on the certificate of the fact that he made the


For Value Received, I hereby sell, assign and transfer unto John Smith, forty (40) Shares of the Capital Stock represented by the within Certificate and do hereby irrevocably constitute and appoint the Transfer Agent of the Company my Attorney to transfer the said Stock on the books of the within named Company with full power of substitution in the premises

Dated December 19 1932,

In presence of

Harry Jones

Faith Jones

NOTICE The signature of this Assignment must correspond with the name as written upon the face of the Certificate in every particular without alteration or enlargement or any change whatever

Form of Assignment of Certificate of Stock

transfer on the books. In large corporations it is usual to engage a trust company as transfer agent and it countersigns certificates to indicate that it has officially made the transfer on the books.[5] A further check is provided in large corpora-

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[4] For a discussion of the effect of taxation on the issuance and transfer of stock, see page 129

[5] A large trust company in New York City publishes the following rates:

TRANSFER AGENT (STOCK)	
Minimum charge per annum—	
For the issuance of 500 certificates and the maintenance of 500 accounts, or any part thereof	$500 00
For the issuance of certificates in excess of 500, each	30
For the maintenance of the next 5,000 accounts in excess of 500, each	40
For the maintenance of the next 15,000 accounts in excess of 5,500, each	35
For the maintenance of accounts in excess of 20,500, each	30
For each out-of-town certificate posted, debit or credit	07½
For posting out certificates on the closing of a transfer agency, the retiring of stock, the combining by transfer or otherwise of certificates into large denominations, etc., per debit certificate	15
For opening up new ledgers when required on account of exchange of stock or for any other reason, per account opened	15
For furnishing reports of transfers	
On all agencies with stockholders up to 2,500 per annum	50 00
On all agencies with stockholders from 2,500 to 5,000 per annum	100 00
On all agencies with stockholders from 5,000 to 10,000 per annum	150 00
On all agencies with stockholders in excess of 10,000 per annum	200 00
STOCKHOLDERS' LISTS	
One list is furnished without charge for each class of stock, for additional lists, for each 1,000 accounts	25 00
For additional copies of lists, for each 1,000 accounts	12 50
REGISTRAR (STOCK)	
Minimum charge (per annum)	
For registration of 500 certificates	250 00
For registering each certificate in excess of 500	15
For each co-registrar in other cities	125 00
For posting out certificates on the closing of a registrar agency or retiring of stock, for each certificate	07½

tions through registration. The transfer agent gives the agent of Faith Jones a deposit slip for 100 shares and tells him that the certificates for 40 and 60 shares will be ready for delivery in a few days. The transfer agent will then take two certificates already signed by the officers of the corporation and will make them up, one for 40 shares for John Smith and the other for 60 shares for Faith Jones He will cancel the old certificate for 100 shares, countersign the new certificates for 40 and 60 shares, and send all three over to the registrar, usually another trust company.[6] The registrar compares the new certificates with the old to see that the new certificates aggregate the same number of shares as the old certificate. He countersigns the new certificate, cancels the old one, and returns all three to the transfer agent The new certificates are then ready for delivery upon presentation of the deposit slip. A receipt is usually required upon delivery The old cancelled certificate is filed away in the transfer agent's office. Eventually it may be cremated by the transfer agent along with other cancelled certificates, upon proper authority.

In the case of an original issue of stock, the registrar makes sure that the certificates issued by the transfer agent do not call for more shares than equal, with the stock already issued, the authorized capital stock of the company. The registrar, from its register, can always tell how many shares are issued and how many shares may be issued.[7]

Under the common law, directors may not place any restrictions on the free transfer of the shares of stockholders. Statutes, however, usually give the directors power to make reasonable regulations to protect the corporation and bona fide stockholders against loss.[8]

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[6] Stock listed on the New York Stock Exchange must be registered with an independent company

[7] For detailed description of procedure for original issuance and transfer of stock, see Doris and Friedman, "Corporate Secretary's Manual and Guide," Chapter 25

[8] Provisions are sometimes inserted in charters or by-laws that stock cannot be sold without first being offered to the corporation or to some other person The courts are inclined to uphold such provisions generally as contracts between the company and the stockholders, so long as the rights of innocent third parties are not injured Thus, where the restriction was stamped upon the stock certificate, it was upheld in New York (Moses v Soule, 63 N Y Misc 203, 136 N Y App Div 904) and in Massachusetts (Barrett v. King, 181 Mass 476, 63 N E. 934) On the other hand, the arrangement was condemned as an

Capital and capital stock.—Some people have difficulty in understanding the difference between capital and capital stock. Capital is the actual wealth or assets of the corporation in money, in tangible property such as a factory, or in intangible property such as goodwill,[9] whereas capital stock is the aggregate ownership in the corporation.[10] Capital varies with the prosperity of the corporation; capital stock, as indicated on page 130, does not vary. One ought to get the idea very clearly that ownership of stock does not really mean ownership of the corporate assets, but ownership of the corporation itself.

Another word that is sometimes confused with capital and capital stock is capitalization. This word is generally used to indicate the total amount of capital liabilities of a corporation, that is, the amount of capital stock plus bonds. In the following abbreviated balance sheet made up from the published statement of a well-known company, the capital is $436,880,095.[11] The capital stock is the sum of items 12, 13, 14, 15, and 16. The capitalization is the same as the capital stock with item 17 added.

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undue restriction on the alienation of property by the courts of Maryland (Victor G Bloede Co v. Bloede, 84 Md 129, 34 A 1127) In Missouri, where nothing was printed on the face of the stock certificate as to the restriction, it was not binding as to third parties without notice (Brinkerhoff-Farris etc Co v Home Lumber Co, 118 Mo. 447, 24 S W 129)

[9] The word "capital" is used in this discussion, not in the theoretical sense in which it is used in discussions of economic theory, or in the legalistic sense, but in the sense in which it is employed in ordinary business transactions Capital, in the legalistic sense, is that portion of the consideration received by the corporation upon the issuance of its stock which the statute requires the corporation to set up on its books as capital, and which cannot be impaired through the payment of dividends or the acquisition of the corporation's own stock Accountants quarrel with this meaning of capital, and tend to consider as capital the entire amount of consideration received by the corporation upon original issuance of its stock See also discussion on page 575

[10] For an instructive analysis of the true nature of capital stock, see the prevailing and dissenting opinions in the well-known stock dividend case, Eisner v Macomber, (1920) 252 U S 189

[11] Sometimes the word "capital" is used in the sense of "net capital" or "net worth," in which case the debts must be subtracted from the assets. In the example given, to find net capital subtract from capital items the sum of items 17, 21, 22, 23, and 24 In analyzing a balance sheet all fictitious assets such as "bond discount" must be eliminated. As to the reserves, good judgment must be used to determine the purpose of each reserve. A reserve for depreciation would be treated as a liability to be deducted. A reserve "for working capital," such as item 19 in the statement given might be called, ought to be treated as a part of the surplus, and therefore should not be subtracted from the assets in determining "net worth"

ABBREVIATED BALANCE SHEET

Assets

1	Property—less depreciation	$304,205,071
2	Investment in and advances to affiliated companies	5,106,553
3	Trustees' account	4,990,396
4	Stock, securities, etc	5,149,554
5	Contingent and insurance fund assets	2,228,921
6.	Deferred charges to operations	859,336
	Current Assets	
7	Inventories	50,938,396
8.	Accounts and notes receivable	35,164,513
9	Marketable securities	483,614
10	U S Government securities	19,668,120
11	Cash	8,085,621
	Total current assets	$114,340,264
	Total assets	$436,880,095
	Liabilities	
12	8% Preferred stock	$30,000,000
13.	7% Cum Preferred stock	20,367,400
14	7% Non-cum Preferred stock	7,040,600
15	Common stock	14,862,000
16	Common stock, class *B*	67,608,500
17	Bonds	156,611,612
18.	Reserves	9,196,235
19	Appropriated surplus	94,000,000
20.	Profit and loss surplus	10,050,674
	Current Liabilities	
21.	Notes payable	1,502,000
22	Accounts payable, etc	23,777,969
23	Interest accrued	1,863,104
24	Coupons payable	.
	Total current liabilities	$27,143,073
	Total liabilities	$436,880,095

Par value and stock without par value.—Sometimes the ownership is appraised, each share being given a par or face value and the entire capital stock then being equal to the par value of a share multiplied by the number of shares. In recent years many corporations have been formed with stock without par value. In this latter case the aggregate ownership is simply divided into shares, and dividends instead of being paid as a percentage on the par value of the share, as is done in the case of stock with par value, are paid at the rate of so many cents or dollars and cents per share.

The issuance of stock without par value was first permitted by the State of New York in 1912. By the end of 1922

thirty-two States had passed similar laws; in 1939 only four jurisdictions remained in which the statutes made no provision for non-par stock; namely, the District of Columbia, Nebraska, North Dakota, and Oklahoma [11a] The growth of the idea in practice is indicated by the following figures in 1912, twenty-six of the 8,757 charters filed with the Secretary of State in New York contained provisions for stock without par value (0.3 per cent), in 1922, of the 18,227 charters filed, 1,996 made provision for non-par value stock (10.9 per cent), in 1938, of the 15,649 charters filed, 8,120 were authorized to issue non-par stock (51.8 per cent).[12]

Advantages of non-par stock.—Stock without par value has positive advantages which may be enumerated as follows. (1) The fictitious values which arise when units of ownership are given an official nominal value are wiped out. (2) Non-par stock permits the corporation to sell its shares from time to time at a price equal to their fair value. The corporation thus avoids the difficulties encountered upon an attempt to raise capital through the sale of additional par value shares when the stock has fallen below par in the market. This difficulty frequently can be overcome only by financing through the issuance of bonds which burden the corporation with fixed charges that further depress the stock of the corporation, or by a rearrangement of the financial structure of the corporation by amendment of its charter. (3) Non-par stock compels investors and regulating commissions to reject artificial preconceptions and to get down to intrinsic values as they are found in assets and earning power. (4) It is frequently easier to obtain the aid of underwriting houses in the sale of additional stock, since the legal difficulties involved in the issuance of par value stock and the payment therefor at par are avoided.

Difficulties presented by non-par shares.—Non-par shares present certain difficulties, rather than disadvantages. While

[11a] Certain types of corporations may be prohibited by statute from issuing non-par stock—for example, financial corporations such as banks, trust companies, insurance companies, building and loan associations, etc The Public Utility Holding Company Act of 1935 provides that stock issued by holding companies for holding company purposes must be common stock with par value. Under certain circumstances, however, the Securities and Exchange Commission may permit the holding company to issue no par value stock

[12] The high percentage in 1938 is interesting in view of the organization tax upon stock without par value See page 130 for an explanation of this tax

the nature of the consideration for which non-par stock may be issued does not differ from that for which stock with par value may be issued, the directors, who usually are authorized by the charter to determine the consideration to be received for the stock without par value, are furnished with no yardstick, as in the case of par value stock, for measuring the amount that is to be paid for the stock. The price is fixed, usually, in the light of legitimate considerations such as appraised and sale value of assets, book values, market values of outstanding shares, present and probable earning power, market conditions, size of the issue, reputation of the corporation, and like influences.

If the directors should fix the price of an increased issue of non-par stock at a figure less than the actual value of existing shares, the interest of the old stockholders in the total net assets will be less than it was before the new stock was sold, since each share after the increase has the identical value of every other share of the same issue. Existing stockholders are protected against such impairment of their capital by their right to apply to a court of equity to prevent a dilution of their shares. Ordinarily, the directors cannot sell the same issue of non-par stock to different persons at different prices, but such sales have been sustained by the courts where it was shown that the transactions were fair and for the beneficial interest of the corporation.

Non-par stock presents certain accounting difficulties concerned largely with determining what part of the consideration paid for the stock is capital In the case of par value shares, the capital of the corporation represented by its stock is the number of shares outstanding times the par value per share. It is important to know what the capital of the corporation is in order to be certain that creditors' rights are not affected by distributions of dividends or retirement of stock. Unless the directors know what part of the consideration received for non-par stock represents capital, they cannot calculate the surplus, and on this important figure depends the declaration of dividends and determination of financial policy. The methods used to arrive at capital where non-par shares have been issued are discussed on page 575.

Taxation of stock with par value and without par value. The effect of taxation on stock with par value and stock without par value should be noted by one who is about to

advise on the organization of a company or on the creation of a new issue of stock. The issuance tax under the Federal law is ten cents on each $100 of face or par value, or fraction thereof, on stock of no-par value, ten cents per share, or if actual value is in excess of $100, then at the rate of ten cents per $100, or if less than $100, two cents for each $20 or fraction thereof of actual value.[13] In some States, for purposes of measuring the organization tax, stock without par value is treated practically as though it had a par value of $100 (See table, pages 82–83.) Suppose, for example, a corporation is to be organized for $1,000,000 in New York, where the organization tax is five cents per $100 of authorized capitalization, and that the question arises as to whether the company shall incorporate with 200,000 shares of stock with par value of $5 each or shall provide for 200,000 shares of stock without par value, but to be sold at $5 each. In either case the Federal tax would be $1,000 if the company is organized before July 1, 1941, and $500 if organized later. But the New York organization tax for the company with stock having par value would be $500, while the tax for the company having stock without par value would be $10,000. In other words, to use stock without par value would cost the company $9,500, a very considerable item.[14]

Authorized, issued, treasury, and outstanding stock.—Authorized capital stock is the amount of stock which a corporation is empowered to issue by its certificate of incorporation It does not change from time to time, unless, of course, the certificate of incorporation is amended.

[13] Revenue Act of 1926, Title VIII, Schedule A2, as amended, re-enacted as Sec 1802, Internal Revenue Code, and amended by Revenue Act of 1939 On and after July 1, 1941, the rates prevailing prior to the amendments are reinstated; that is, the ten cent tax is reduced to five cents, and the two cent tax is reduced to one cent

[14] Perhaps the organizer of the company referred to will be foresighted enough to take into consideration not only the organization tax in the case of the State and what corresponds to it in the Federal revenue system, namely the tax on the issuance of stock, but also the stock transfer taxes of both the State and Federal governments. This tax for New York, for the period from June 1, 1933 to June 30, 1940 is three cents per share (whether par or no-par stock), but if the selling price is $20 or more per share, the tax is four cents per share After June 30, 1940, the rate is one and one-half cents per share (whether par or no-par stock), but if the selling price is $20 or more per share, the tax is two cents per share (For current information on stock transfer laws of the several States, see Prentice-Hall Stock Transfer Service) The Federal tax for the period beginning June 21, 1932 to and including June 30, 1941, is four cents per $100 or fraction thereof of face value, or in case of stock without par value it is four cents on each share. However, if the selling price is $20 or

Authorized stock is divided into unissued and issued stock, which terms explain themselves. Before any stock is bought, all the authorized stock is unissued. As it is bought and paid for, the company issues it. Sometimes stock is subscribed for and partially paid. It is then said to be "callable stock," for the directors may issue calls from time to time demanding payment of part or all of the unpaid portion. If the directors may demand more than the par value of the stock, the latter is said to be "assessable." This form of stock has been abolished by law in many States. Where stock is part paid, the corporation may either withhold the certificate till the stock is paid in full or may issue the certificate immediately and mark it "part paid."[15] The effect of these operations we shall consider presently.

When stock has been issued and is in the hands of an outsider, it is said to be outstanding. Sometimes a corporation will obtain, by purchase or gift, some of its own stock, which in such cases will be called "treasury stock."

These definitions may be summarized as follows:

$$\text{Authorized stock}\begin{cases}\text{Issued}\begin{cases}\text{Part Paid}\\ \text{Full Paid}\end{cases}\begin{cases}\text{Outstanding}\\ \text{Treasury}\end{cases}\\ \text{Unissued}\end{cases}$$

Liability of stockholders to pay for stock.—At common law a stockholder is liable to pay for his stock what he has

more per share, the rate is five cents instead of four cents On and after July 1, 1911, the four cent tax is reduced to two cents and the five cent rate does not apply in any case Neither the New York nor the Federal tax is incurred upon original issuance of the stock But let us suppose that in the course of a few years there will be sales of stock equivalent to a complete turnover, that is, that 200,000 shares will be sold. During the period of the emergency tax rates, in the case of stock with par value the Federal taxes on $1,000,000 face value would be $400, whereas in the case of stock without par value the taxes would be $8,000 In other words, a transfer of $1,000,000 worth of stock would cost $7,600 more if it had no par value than if it were given a nominal value The calculation on the basis of rates applicable at the expiration of the emergency periods shows that a transfer of $1,000,000 worth of stock would cost $3,800 more if it had no par value than if it were given a nominal value While these transfer taxes are not paid by the company, the company may wish to consider their effect on the marketability of its shares.

[15] It would seem that where a corporation is not prevented from doing so by statute, it may issue certificates before stock is fully paid and pay dividends on its par value even though other shares are paid in full See A. Machen, "Modern Law of Corporations," page 433 As to States not permitting issue of certificates, see W. M. Fletcher, "Cyclopedia of the Law of Private Corporations," Vol. 11, §5161 Usually a corporation will agree to pay "interest" on installments at the current dividend rate Sometimes interest is paid at a rate lower than the dividend rate See C W Gerstenberg, "Materials of Corporation Finance," page 1014.

agreed to pay. By statute in most States this liability is increased in favor of the creditors of the company, so that if a person holds stock which has not been paid up to the par value, he will be liable, in case of the insolvency of the corporation, to pay, as far as is necessary to pay the debts, the difference between the par value of the stock and the amount that has been paid thereon. Where stock has no par value, the amount that should be paid for stock—that is, the amount that corresponds with the par value—is usually settled by the directors before the stock is issued This amount may vary from time to time, depending on what the directors think the stock is worth, but when it is fixed the amount may for the purpose of fixing the stockholders' liability be considered the par value of the stock.[16]

How stock may be made "paid up" or "fully paid."—In most States stock may be paid for in cash, property, or services. In some jurisdictions, as for example, Massachusetts, Great Britain, and France, the laws are very strict as to the valuation of property or services paid for in stock. This is especially true under the French law, where property turned over to the corporation is appraised by a special *commissaire* appointed to appraise the property (*apports*) and where the owners of stock received for property are not permitted to negotiate it directly for two years after it has been received

Where it is desired to sell par value stock below par and to limit the holder's liability to the amount he agrees to pay for it, the customary practice is to issue the shares in the first instance for some such property as a mine, or a patent, or for goodwill valued at the par value of the stock issued therefor. The vendor of the property then returns to the company a part of the stock he receives, and, since it has been paid in full with the property, it may, as treasury stock, be sold at any price. The fact that the person who has received the stock gives a part of it back gratuitously does not necessarily

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[16] In Canada and England, if the corporation does not include the word "Limited" as a part of its name, the stockholders are liable unlimitedly as partners In a few States the word "Limited" or the abbreviation "Ltd" following the name of the corporation may be used in lieu of "Corporation" or "Inc." to indicate that the organization is a corporation with limited liability of stockholders The laws of the several States must be studied carefully to determine the amount of liability in each jurisdiction and the conditions under which the liability arises In many States stockholders have more or less unlimited liability for debts due laborers for wages.

mean that his property was originally overvalued. That is a separate question of fact that must be determined from a fair appraisal of the property. If a fair appraisal shows the assets to be worth palpably less than the par value of the stock, the latter is said to be "watered." Where "stock-watering" is proved, the holders are generally held liable as they would be if they had paid for the stock an amount of cash equal to the appraised value of the assets.[17]

A mine owner has a report on his property showing it to contain $10,000,000 of ore which can be extracted at a cost, including marketing and administrative expenses, of $4,000,000. He turns the mine over to a corporation for $6,000,000 of its stock, fully paid, and gives back $2,500,000 of the stock to the corporation which the latter may now sell at any price One can hardly call this an overvaluation of the property. The mine owner is willing to take only a part of the stock in order that he may get the money to turn his potential buying power into an active business that will yield him universally acceptable money Treasury stock under the circumstances outlined above can be given away as a bonus without rendering the holders liable.

Forfeited stock.—When stock is part paid, the unpaid balance is usually subject to "call," that is, the directors may call for payment of part or all of the unpaid portion, provided, of course, all stockholders are treated alike. Subscription agreements to stock usually provide that where such calls are not met, the stock may be sold for the benefit of the defaulting stockholder. Thus, if *A* owned 100 shares, 50 per cent paid up, and a call was made for $10 a share, *A* would either have to pay the $1,000 or the corporation would sell his stock at the best price it could get. If *B* bought the shares for $80 each, $50 would be used to make the stock "fully paid" and the remainder, less expenses of the sale, that is, $3,000, would be returned to *A*.[18] The exact rules on forfeiture must be consulted in the statutes of the several States

[17] An interesting, and doubtless authentic, account of the origin of the term "watered stock" will be found in Chapter VI, Bouck White, "The Book of Daniel Drew" On the legal aspects of watered stock, see W M Fletcher, "Cyclopedia of the Law of Private Corporations," Vol 11, §5199 *et seq*

[18] For forms of subscription giving to corporations the right to retain installments paid as liquidated damages, see S. Gordon, "Standard Annotated Forms of Agreement," Form 156.

Classification of stock.—The most usual classification of groups of stock is that which divides them into common and preferred. In England such shares are generally called "ordinary" and "preference" shares. Formerly, the class of stock with special rights was known as preferred stock and the class with ordinary rights as common, but the practice of making limitations on the rights of shareholders became so prevalent that frequently preferred stocks were not preferred at all. Hence arose a new method of naming stock Class "A," Class "B," and so on. Later variations of this method of classifying stock show a division of the preferred and common stock into Class "A," "B," and so on for each. The classification of preferred stock has become usual through the issuance of such stock in series, as explained on page 135.

The classification of common stock into Class "A" and Class "B" came about largely to meet the demands of investors for a share in the increased profits enjoyed by corporations during and following the World War. From 1925 to 1930, when common stocks were again in demand because of large earnings, classified common stock was provided for by many new corporations and by corporations that were changing their financial structure. Usually the Class "A" common stock is promised dividends at a liberal rate and is made participating in the profits along with Class "B" common after a definite rate has been paid to the Class "B" stockholders. Almost invariably the voting power in a corporation with classified common stock rests with the Class "B" stockholders, Class "A" being non-voting except possibly upon default in dividend payments.

The New York Stock Exchange has established certain standards for preferred stock and will not list a stock as "preferred" unless those standards are met. For example, a $5 convertible preferred stock that would be entitled to cumulative dividends only to the extent earned in any one year would not be listed under any name above Class A common.

Preferred stock.—Preferred stocks came into existence with the railroad reorganizations of the nineteenth century and were used, as they are used today, to give investors something better than common shares, but not quite as safe as bonds.[19] The preferred stockholder usually has the rights of

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[19] See W. Z. Ripley, "Railroads, Finance and Organization," page 95.

a common stockholder except that he is to receive a share of the profits annually before any profits are distributed to the common stockholder. Gradually, various extra rights or protections were given the stock, or limitations were placed upon it, and we have today, therefore, many different kinds of preferred stock. The most important of these variations we shall explain below.

Preferred stock in series.—In recent years the corporation laws of some of the States have provided that preferred stock may be issued in series, with such preferences, restrictions, and limitations for each group as are fixed from time to time by resolution of the board of directors. Because the participation in the corporate income, preferences, and other privileges are not set forth in the certificate of incorporation, this form of stock has sometimes been called "blank" stock. The directors give to a block of the preferred stock at the time they undertake its sale such attributes as will make it marketable. Before series stock was authorized, a corporation could issue no other stock but that having the attributes prescribed by the charter; without an amendment of the charter no other stock could be issued, regardless of the financial position of the corporation and the suitability of the provisions of the issue to the demands of the times. It is not uncommon, as a result of the provision authorizing the issuance of preferred stock in series, to find one corporation issuing a series of stock called the $7 series and another called the $6 series, or a series of 7 per cent and another of 6 per cent preferred stock. The General Gas & Electric Corp. has authorized 660,000 shares to be issued in series. Under this authority it has issued the following classes of preferred stock $8 cumulative preferred series "A," $7 cumulative preferred series "A," $6 cumulative preferred series "A," and $6 cumulative preferred series "B."

Participating and non-participating preferred stock.—Where two classes of stock are mentioned in a certificate of incorporation and one is called common and the other merely "7 per cent preferred," some courts will decide that the preferred will be "participating"; this means that the preferred is to be paid 7 per cent before the common shares; then, if profits are left, the common will be given 7 per cent; and if there are any profits left after that, the two classes will be regarded as one class for any further distribution of profits

The reasoning on which this principle is based is that the preferred stockholders yield nothing in compensation for the benefits which they receive; but they hold all the rights of the common shareholders in addition to their preferential rights Other courts will hold that the preferred will be "non-participating"; that is, that the common stockholders are entitled to all the surplus earnings after the prior rights of the preferred stockholders have been safeguarded The reasoning on which this principle is based is that in receiving the greater security for his preferential right, the preferred stockholder impliedly agrees to accept such right in lieu of equal participation.

The terms of the contract under which preferred stock is issued may definitely prescribe whether the stock shall be participating or non-participating. Thus, the Preferred "A" of the Wabash Railway Company and the preferred stock of the A. M. Byers Co are participating The second preferred of the Pacific Coast Company is participating, while the first preferred is not. The preferred of the American Smelting and Refining Co and the preferred of the American Locomotive Co are non-participating.

These arrangements are purely contractual; that is, the different classes of stockholders in accepting their stock make a contract with the corporation and with one another to abide by the provisions of the certificate of incorporation. These provisions may be made in as many different ways as the founder of a corporation may imagine. The following examples will give some idea of typical arrangements of this kind

Chicago & Northwestern Ry.. preferred 7 per cent, common 7 per cent, then preferred 3 per cent additional, then common 3 per cent, then both classes share equally.

Seaboard Air Line Ry.: preferred 4 per cent, common 4 per cent, preferred 2 per cent, common remainder.

Canada Steamship Lines, Ltd.: preferred gets 6 per cent and is entitled to additional 1 per cent if dividends of 3 per cent per share are paid on the common, and a further additional 1 per cent if more than $3 per share are paid on the common.

Non-cumulative and cumulative preferred.—If the preferred stock is described as non-cumulative and dividends have not been declared upon the stock, the dividends omitted in any year do not accumulate and need not be made up, even though earned for the year in which the dividend has been

omitted.[20] In other words, since the Wabash Railway case, earnings can be applied in any year by the directors to necessary corporate purposes, such as an expansion program, instead of to dividends on the non-cumulative preferred stock, and the stockholders can do nothing about it, provided the directors have acted in good faith. This being the rule, preferences in dividends are subject to manipulation. We may assume a case where the directors hold common stock amounting to $100,000 and the outsiders hold $100,000 of 8 per cent preferred stock Let us suppose, further, that a fair system of accounting would reveal a profit of $8,000 a year If this were divided properly, the preferred stock would get $8,000 and the common stock would get nothing. By a form of manipulation known even to the novice in accounting, the directors might show on their books no profits in one year, and, by reversing the process, a profit of $16,000 in the alternate years. Thus every other year the preferred would get its $8,000 and at the same time the common would also get $8,000. Each class would average $4,000 a year, whereas the preferred should get each year $8,000 and the common nothing.[21]

To prevent this form of manipulation, preferred stock is usually made cumulative, so that if the specified rate is not paid for one year, there arises an arrearage which must be made up in subsequent years before the common can participate in the earnings. Ordinarily, if nothing is said on this subject in the certificate of incorporation, the law will hold the stock to be cumulative and not non-cumulative. Where preferred is cumulative and dividends are not paid, the arrear-

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[20] This conclusion of the Supreme Court in Barclay v Wabash Railway (1930) is contrary to the holdings of several courts which earlier had decided that the directors could not withhold dividends on non-cumulative stock in years when the corporation had earned sufficient to pay dividends or proceed to pay dividends on the common stock in following years before making up the dividend on the preferred stock which had been earned and omitted See Bassett v U S Cast Iron Pipe & Foundry Co , (1908) 74 N J Eq 668, 70 Atl 929, affd (1909) 75 N J Eq 539, 43 Atl 514; Day v U S Cast Iron Pipe & Foundry Co , (1924) 94 N J Eq 389, 123 Atl 546, affd on appeal 96 N J Eq 738, Collins v Portland Electric Power Co , (1925) 7 F (2d) 221, affd 12 F (2d) 671 The question of whether there is any control over the board's power to manipulate its dividends so that common stock may profit at the expense of the non-cumulative preferred stockholders is still vigorously debated.

[21] See illuminative articles by A A Berle, Jr , in 23 *Columbia Law Review* 358, and W. H. S. Stevens, in 34 *Columbia Law Review*, 1439.

ages when made up ordinarily do not bear interest. Moreover, if they accumulate to a large amount, as they did in many corporations during the depression of the thirties, they become a burden to the company in connection with future plans for financing, and in general are finally eliminated through some plan of recapitalization. The reader may care to investigate the attempts to clear up arrearages on the preferred stock of the American Hide and Leather Co., on which over 140 per cent was due.[22] The capitalization was finally readjusted in 1925 and the accumulations wiped out. Another accumulation of dividends on American Hide and Leather preferred stock of $217 75 a share was wiped out in the recapitalization plan of 1935. In 1939 another accrual of unpaid dividends of $2 per share was cleared up.

Sometimes stock is issued as non-cumulative and becomes cumulative after the lapse of a few years. This gives the corporation time to get on its feet before it is subjected to the handicap of preferred dividends in arrears. An example is Austin Nichols preferred, cumulative after February 1, 1934 To prevent a burdensome accumulation of arrears, a limitation may be placed upon the cumulative feature. Thus, the preferred stock of Alabama Great Southern R. R. Co is not entitled to any payment of arrears exceeding six years.

Protected preferred stock.—The cumulative feature looks backward to clear up dividends in arrears. Protected preferred stock, which was first issued, so far as we know, in the promotion of the May Department Stores Company in 1910,[23] looks forward and provides that profits must be conserved to pay shortages in preferred stock dividends in the lean years when current profits are insufficient.[24]

The plan of protected preferred stock is best illustrated by the diagram on page 139.[25]

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[22] For similar difficulties of the old United States Leather Co (later Central Leather and now again the United States Leather Co) see A S Dewing, "Corporate Promotions and Reorganizations," pages 16–48

[23] The protected preferred stock of the May Department Stores Company was retired in 1927 See footnote 25

[24] Probably the idea of protected preferred is derived from the French Corporation law which has been copied by most of the countries on the continent. Article 36 of the Law of 1867 provides that the company must put aside five per cent of its net profits annually as a reserve fund until the fund is equal to ten per cent of the capital

[25] The details of protected stock are not the same in every case. The example given is a fair representation of what may be expected. For other examples, see the J. I. Case Co., and Franklin Simon & Co.

A is the corporation; *P* a place representing the preferred stock, with sides equal in height to the stipulated rate of dividend, say 7 per cent. *R* is a fund, in the case of some corporations called the "Special Surplus Account." *C* is the common stock. The certificate of incorporation provides that the flow of earnings must first be used to pour 7 per cent on the preferred stock. The overflow then goes into the special surplus. We may imagine that this reservoir has spigots

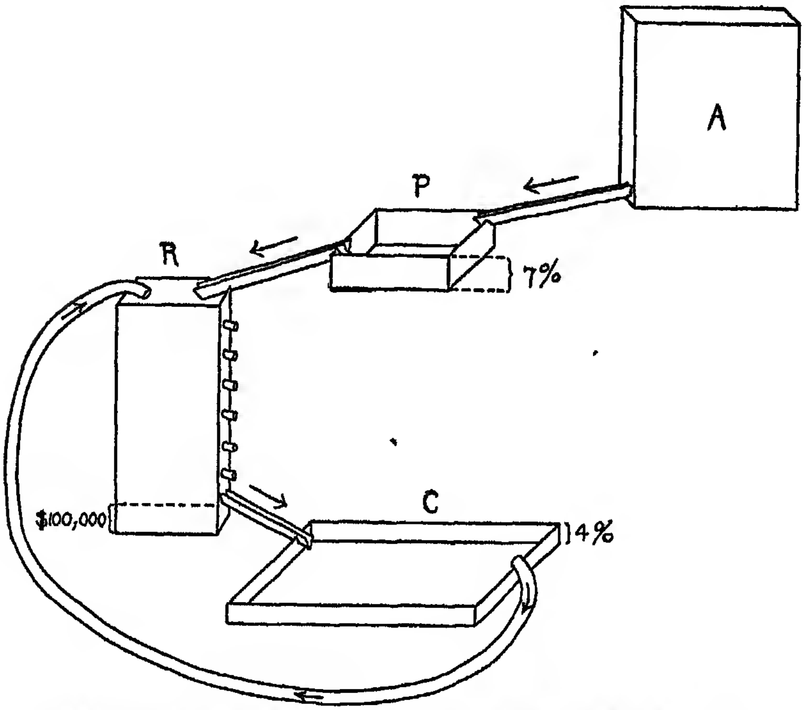

Diagram Showing Flow of Profits in a Company Whose Dividends on "Protected" Preferred Stock are Secured by a "Special Surplus Account"

at regular intervals, say $100,000 apart. As soon as the special surplus is filled up to the first spigot the profits flow out upon the common stock, which has a wall about it equal in height to 4 per cent. When the common stock plane is filled to overflowing, the profits are devoted to the special surplus and the spigots are automatically closed to hold the overflow profits Each year the profits of the company may flow through the same channels, giving the preferred stock 7 per cent and the common stock 4 per cent, until the special

surplus is entirely filled, at which time, after the preferred gets its current 7 per cent, the remaining profits may go to the common. Let us suppose that after $400,000 has been placed in the special surplus the corporation one year fails by $200,000 to make enough to pay 7 per cent out of current earnings on the preferred stock. The corporation will simply draw on the special surplus for $200,000 But since in the poor year the corporation should have put $100,000 into that fund instead of taking out $200,000, it will have to put $400,000 into the fund the next year before the common stock can share in the profits—$200,000 to make good the draft, $100,000 due for the past year, and $100,000 due for the present year to go into the fund before the proper spigot is reached out of which dividends can flow to the common stock. Very often the fund is to be used also for redeeming the preferred stock This use of the fund really protects the dividends, since it reduces the size of the plane on which the 7 per cent dividends must flow.[26]

Variations in risk.—We have described the usual variations in stock that affect control and income; now let us briefly consider variations in risk As will be shown later in this book, stockholders are the risk bearers, that is, they are the last people to be paid out of the proceeds of the dissolution of a corporation But they may agree among themselves to share the risks in different degrees. Thus preferred stock may be made preferred as to assets as well as to dividends. In that case the holders of such stock will be paid back the par value of their stock out of what is left after satisfying the creditors, before the other class receives anything. Sometimes this provision is made "non-participating," by which is meant that although the preferred stock will get one hundred cents on the dollar before the common shares get any, if the company does have abundant assets the common stockholders will not only get back their capital, but all the profits as well.[27]

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[26] For provisions in the certificate of incorporation of the May Department Stores Co covering this device for its 7% cumulative preferred stock, which was retired in 1927, see C. W. Gerstenberg, "Materials of Corporation Finance," pages 107–110

[27] For further explanation of this subject see page 764. Preferred stock of the United States Steel Corporation is non-participating See C W Gerstenberg, "Materials of Corporation Finance," page 61. See also *ibid*, pages 103 and 110.

Redeemable or callable stock.—Sometimes stock is made redeemable or callable. The option to accomplish this always belongs to the corporation, because the redemption can take place only to the extent that the corporation has a surplus. Thus the original capital is not returned to the stockholders, but they are given the profits of the company provided they surrender their stock The shares to be redeemed are frequently drawn by lot, though in some instances the redemption is pro rata, that is, an equal proportion of the shares of each stockholder is called In most cases stock can be, and often is, bought in the open market at not more than the redemption price Most of the preferred stocks issued in recent years have been made redeemable

Where there is no provision in the charter for redemption, the company may attempt the same thing by buying in its stock. Such purchases may be made by separate negotiation, by purchase through a broker on one of the stock exchanges, or through a general offer to the stockholders to purchase shares of stock from them. Such purchase is usually sanctioned by the courts, provided the assets used for that purpose are not needed for taking care of the present creditors [28]

Whether stock that has been redeemed may be reissued, depends on the charter and on the local statutes. Frequently, the charter provides that redeemed stock shall be canceled

Redemption may affect control.—Where several classes of stock are outstanding and one with voting power is redeemable, the corporation may wipe out its voice in the control by redeeming it.[29] Thus, in 1917, a Massachusetts corporation, the Union Mills, Inc., wanted to change its domicile by reincorporating in New York Those stockholders who consented received the New York company's stock for their old stock. The stock of those who neglected to register their assent was redeemed and thus the old company got rid, in one way or another, of all its stockholders.

Other effects of redemption.—The redemption feature may keep the price of a stock down, for people will not be willing to pay much above the redemption price if they are

[28] See W M Fletcher, "Cyclopedia of the Law of Private Corporations," Vol 6, §2845 *et seq*

[29] See W Z Ripley, "Railroads, Finance and Organization," page 495 See for example the story of the quarrel between Hill and Harriman in the Northern Pacific corner of 1901, G. Pyle, "The Life of James J Hill," and J G Kennan, "E H Harriman."

likely to get the redemption price back shortly after their purchase. For example, in 1913 National Lead preferred, which was paying 7 per cent dividends, sold at 108, while the common paying 3 per cent sold at 60. The preferred ought to have sold at 140, then its *yield* on the amount of the investor's capital tied up in the stock would have been 5 per cent—the same yield as that on the common. But people were unwilling to put $140 into a share of preferred which was redeemable at par, and which, according to rumor, was actually "slated" to be redeemed. To prevent a similar situation, preferred is often made redeemable at a price above par. Usually the redemption price includes all dividends in arrears. Notice of redemption is generally required, from ten days to several months being not unusual, and the actual date of redemption is generally required to be one of the regular dividend dates.

An interesting example of the effect of redemption on income was the redemption at 130 of 25,000 shares of preferred stock of the Washburn Wire Company. The premium cost the company $750,000, but it helped the common stockholders, since the charter provided that the preferred stockholders should share equally with the common stockholders in all earnings after the common had received 8 per cent, and also because the company was in a position to pay large dividends. An occasional complaint of common stockholders is that the company has failed to take advantage of opportunities to redeem an outstanding issue of preferred stock and thereby strengthen the dividend prospects of the common.

Sinking fund stock.—Redemption also is looked upon as affecting risk. Ordinarily, a stockholder does not get his investment back from the company until it dissolves. If he is to get it back sooner, his risk will terminate sooner.[30] When redemption is based on a provision requiring the company to set aside out of earnings every year a certain fund looking eventually to the accumulation of an amount large enough to retire the entire preferred stock issue, risk, it is believed, is reduced to a minimum. Where a fund is set aside, it is usually calculated as a percentage of the amount of preferred

[30] In practice, the stockholder may get his investment back, less losses, by selling to an outsider. In the case of large corporations with listed stock, the ability to "liquidate" the investment is an important element of the investment status of the stock.

stock outstanding, or a percentage of the net income, or it is fixed at a minimum in dollars to be set aside before dividends can be paid on the common stock, or before dividends can be paid on the common stock in excess of a given rate. Shell Union Oil Co. is a fair example.

Convertible stock.—Convertible stock is stock that is convertible into some other form of security. Usually, conversion is at the option of the stockholder and permits the conversion of senior securities into junior securities of the same company. A wide demand for convertible preferred stock developed during the prosperous years 1925–1929, largely on account of the phenomenal rise in the values of common stock during that period. Moody's "Manual of Industrials for 1938" lists about five hundred industrial convertible stock issues, somewhat less than the number that appeared in its 1930 compilation.

An example of the value of the convertible privilege is found in the case of the Gulf States Steel Co. In 1917, the first cumulative 7 per cent preferred stock, preferred as to assets as well as to dividends, sold at 115, while the second preferred, which was non-cumulative and paid only 6 per cent, sold at 190. Why the difference? The second preferred was convertible into common, and since both preferred issues were non-participating and since the company was enjoying large earnings, the second preferred was able to participate in this prosperity through conversion into the common. A great many of the holders of the second preferred stock took advantage of the situation. The balance sheet of the company for 1916 showed $1,685,000 of this issue outstanding. It was reduced to $860,000 in the 1917 balance sheet, and to $85,700 in the 1918 statement. By 1924, all the second preferred stock had been converted into common stock.

If a class of stock is redeemable, the company may in effect exercise the option of conversion by calling the stock for redemption and then offering in place of cash another class of stock. Burns Brothers, the large eastern retail coal company, effected a conversion in that way in 1917.

Stock ordinarily cannot be made convertible into bonds except at the option of the company; otherwise, stockholders would convert their stock into bonds when a company became insolvent and thus would get an advantage over

creditors. A rule contrary to the one given would permit the stockholders to have their cake after eating it.

Where conversion of stock into bonds at the option of the company is permitted, it is limited to an amount equal to the surplus or undivided profits of the company. This prevents the breach of a well-known rule of corporation law, that the corporation cannot directly or indirectly give back to the stockholders any of their contributed capital except through an amendment of the certificate of incorporation.

Where one class of stock is convertible into another class, and one or the other has limited voting powers, a conversion of one class into the other will affect the voting control of the company.

Conversion rate or price.—The conversion instrument expresses the rate at which the corporation will exchange the convertible shares, upon exercise of the conversion privilege, in terms of the number of shares into which the security is convertible, generally called the "conversion rate," or the price per share at which the new shares are issuable, generally called the "conversion price." In the case of industrial convertible issues, the rate is usually expressed in terms of so many shares of common stock for each share of convertible preferred. For example, the conversion rate of the $5 convertible prior preferred stock of the American Zinc Lead & Smelting Co. is four shares of common stock for each share of prior preferred stock The conversion privilege of the 5 per cent non-cumulative preferred stock of the Hudson & Manhattan R. R. Co. is expressed not as a certain number of common shares for each share of preferred stock, but as one share of common stock taken at $110 a share for one share of preferred; this means that to receive ten shares of common the holder of preferred stock must give up eleven of his shares.

Limiting the conversion period.—An increase in the earnings of the corporation, which will be reflected in the market price of its common stock, will cause many of the convertible security holders to exercise their privilege. If the corporation wishes to be able to force a conversion, which it is likely to desire when the earnings of the corporation are causing the value of the common stock to rise out of all proportion with the "conversion rate" or "conversion price" as originally worked out, it may make the convertible stock redeemable at a fixed price at any time upon a certain number of days'

notice. For example, the United Biscuit Co. 7 per cent convertible preferred stock is callable at any time on sixty days' notice at 110. The conversion privilege on redeemable stock usually extends to any time on or before the redemption date.

Another method of limiting the time during which, conversion may take place is to fix a final date for the exercise of the conversion privilege. For example, the 5¼ per cent cumulative preferred stock of the American Brake Shoe and Foundry Co. is convertible into common stock at any time up to June 30, 1941.

Some issues of convertible stock provide different conversion rates for different conversion periods, giving the first period the most favorable conversion price, and thus encouraging early exercise of the conversion privilege. For example, the Continental Department Stores, Inc. $3.50 cumulative convertible stock, Series "A," was convertible into one non-par common share at any time up to December 31, 1930, inclusive, into three-quarters of a share of common up to December 31, 1932, inclusive, and into one-half share of common up to December 31, 1934

Dilution or change of the conversion privilege.—Where one class of stock is convertible into another class, any change in the financial structure of the corporation may dilute, change, or destroy the conversion privilege, and the corporation as well as the holder of the convertible securities must watch the effect of a proposed change. The following changes, for example, may reduce the value of the conversion privilege: a split-up of the shares issuable upon conversion, or a change in such shares; a stock dividend; a sale of additional shares issuable upon conversion for less than a certain price; the issuance of subscription rights; the distribution of assets to the holders of senior securities; the issuance of other classes of stock having a preference upon redemption, liquidation, or dissolution; the issuance of another class of convertible securities offering the privilege of conversion into the same class of stock at a price lower than that offered to the first class of convertible stock. A consolidation, merger, sale of assets, or dissolution may wipe out entirely the conversion privilege.[31]

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[31] For a full treatment of this subject, see Hills, "Convertible Securities Legal Aspects and Draftsmanship," *Columbia Law Review*, November, 1930

Protection against dilution of conversion privilege.—Unless the corporation has obligated itself by contract to protect the holders of convertible securities against dilution of their conversion privilege, it is not required by law to do so, for, as Mr. Justice Holmes has stated, the conversion privilege is simply an option to take stock as the stock may turn out to be when the time for choice arrives [32] Usually, however, the document setting forth the terms of the conversion—that is, the certificate of incorporation in the case of convertible stock, and the deed of trust or trust indenture in the case of other convertible securities—contains provisions to protect the interest of holders of convertible stock against dilution, change, or destruction of the conversion privilege. The protection aims, through restrictions and adjustments of the conversion price, to give the holder of the convertible stock what he would have received had he converted his shares immediately before the change affecting the conversion privilege.

Thus, the protection afforded in case of a split-up or combination into a lesser number of shares of the stock issuable upon conversion, takes the form of a provision that the number of shares issuable upon conversion shall be replaced by the number of the subdivided or consolidated shares, as the case may be. Protection of the same order is provided in case the shares issuable upon conversion are changed into the same or a different number of shares of any other class or classes.

One form of protection against a stock dividend is to provide that the holder of the conversion privilege shall be entitled to receive the shares therefor issuable upon conversion, together with the dividend stock which would have been issuable if the conversion privilege had been exercised immediately prior to the record date of the stock dividend.

The protection against the issuance of additional shares at less than a fixed price is an adjustment in the conversion price. An excerpt from the certificate of incorporation of the United Artists Circuit, Inc. illustrates a common form of price adjustment:

The price at which common stock shall be issued upon conversion of preferred stock shall be forty dollars ($40) per share (hereinafter called

[32] Parkinson v. West End Street Ry Co., (1899) 173 Mass. 446, 53 N. E. 891.

the basic conversion price), provided, however, that in case common stock in addition to the five hundred thousand (500,000) shares of common stock to be presently issued, shall be issued as a stock dividend or at a price or prices which shall net the Corporation less than forty ($40) per share, then the conversion price (hereinafter called the reduced conversion price) for each share of such common stock shall be determined in the following manner The aggregate value of said five hundred thousand (500,000) shares of common stock at the basic conversion price per share, plus the aggregate amount of money, or the value in money of the property, if any, for which all additional common stock shall have been issued or sold shall be divided by five hundred thousand (500,000) increased by the number of shares of all additional common stock issued or sold other than upon the conversion of preferred stock, and the quotient resulting from such division shall be the price per share at which common stock shall be issued upon conversion of preferred stock; . . .

To illustrate the mathematical working out of this adjustment, let us suppose that the above company issues 100,000 additional shares of common stock at $30. The reduced conversion price would be found to be $38.333 as follows:

$$\frac{(500{,}000 \times 40) + (100{,}000 \times 30)}{500{,}000 + 100{,}000} = \$38\ 333$$

This is the simplest method of conversion price adjustment. In many instances, because of changes in the conversion price from period to period, elaborate methods of conversion have been provided.[33]

A further protection against the dilution of the conversion privilege requires that, in the case of a stock dividend upon the shares issuable upon conversion, or distributions other than cash dividends at a certain rate per share in any one year to the holders of the shares issuable upon conversion, or in case of the authorization or offer for subscription of additional shares issuable upon conversion, the corporation shall give the holders of the convertible shares previous notice of the day (whether or not determined by closing the books) as of which the stockholders of record shall be entitled to participate in such dividend, distribution, or subscription rights, in order that the holders of the convertible shares may exercise their conversion privilege and be entitled, in respect to the shares resulting from the conversion, to receive such dividends, or other distribution, or to exercise such subscription rights, as the case may be.

[33] See, for example, the adjustment provisions in the indenture of the American I G Chemical Corporation, and I G Farbenindustrie Aktiengesellschaft, with the National City Bank as Trustee, dated May 1, 1929.

The protection against destruction of the conversion privilege in case of consolidation, merger, or sale of assets is illustrated with regard to convertible bonds on page 254. A similar provision can be made for convertible stock.

Convertible stock and the market.—The convertible issues of a corporation will frequently reflect the market position of the stock into which the shares are convertible. Thus, if the corporation is prosperous and its shares issuable upon conversion rise on the market, the convertible shares will also go up in price. If the earnings on the shares issuable upon conversion decline, the convertible preferred shares will decline also, but they will always maintain a relationship to the value of the securities aside from the conversion privilege. For example, notice the price range of the stock of Hershey Chocolate Corporation which had outstanding, in addition to common stock, a 6 per cent cumulative prior preferred stock (non-convertible) with a first preference as to assets and dividends, and an issue of convertible preferred, non-par stock which had a second preference as to assets and dividends ($5 per share) and was convertible share for share into common stock.[33a] During 1927–1929 the price range of these shares was as follows:

	1927	1928	1929
Prior preferred	101½–99⅝	105 –100¼	106⅜–104
Convertible preferred .	75½–70¼	80 – 70¼	143¼–60⅝
Common .	40¼–31⅛	72½–30¾	143⅞– 45
Earnings per share of common ...	$3.45	$6.59	$8.13

Frequently the corporation, or the bankers who have marketed the stock of the corporation, will want to maintain the market price of the corporate securities in the interest of future financing. If the corporation has both convertible preferred stock and common stock outstanding, it is necessary to support only the price of the common stock, for the convertible feature of the preferred stock will cause that stock to move in harmony with the stock into which it is convertible.

Since convertible preferred stocks do not have the security or stability of convertible bonds, the use of convertible preferred stocks to cover the short sale of common stock is hardly possible. For an explanation of the use of convertible bonds to cover short sales of stock, see page 249.

[33a] The 6% cumulative prior preferred was retired during 1930. The convertible preferred thus acquired a first preference as to assets.

Stock purchase warrants.—Closely related to convertible preferred stocks are preferred or senior issues of stock that carry with them warrants entitling the holders to purchase common stock of the corporation at a certain price. This feature, like the convertible feature, makes the securities to which it is attached attractive and marketable at the time of original issuance Purchasers who want the security of a preferred issue with the possibility of a speculative profit, will buy the stock to which the stock warrant attaches, expecting to exercise the warrant if the stock purchasable therewith should rise in value above the price at which it can be acquired with the warrant [33b]

Stock purchase warrants have been attached to issues of common stock and in many instances to issues of bonds and notes They have also been issued along with shares given in exchange for securities upon consolidation of corporations, and upon reorganization of corporations Option warrants, otherwise known as stock purchase warrants, have also been issued independently of any sale or exchange of securities.[34]

The essential difference between the convertible feature and the stock purchase warrant is that the warrant is exercised by the purchase of the common stock for cash, while the conversion privilege is exercised by the surrender of the convertible stock for the stock given in exchange therefor. The corporation's capitalization increases with the exercise of the warrants, whereas in the case of convertible securities one class of securities is diminished and another increased Some instruments creating stock purchase warrants provide that part or all of the proceeds received from the exercise of warrants shall be used to retire preferred shares by redemption or purchase at a price not exceeding the redemption price, thus checking an expansion of capitalization.

[33b] Warrants have been used solely to provide a method of promoters' profits without "watering" the capital structure of the corporation The perpetual option warrants issued by United Corporation are an example For a discussion of these warrants, and of objections in general to perpetual warrants, see 37 *Columbia Law Review* 798

[34] Stock purchase warrants offered publicly, independently of any sale or exchange of securities, must be registered under the Securities Act of 1933, whether they are exercisable immediately or in the future, since they come within the definition of a security Stock purchase warrants offered in connection with an issue of securities must be registered with the security, if the security is required to be registered

Detachable and non-detachable warrants.—Warrants are usually detachable instruments that may be purchased and sold apart from the security to which they were originally attached. In many cases, however, the warrant is made non-detachable, or non-detachable for a certain period and thereafter detachable. If the warrant is non-detachable, there can be no market in warrants alone, and the warrant may be exercised only by presentation thereof attached to the stock certificate or other security. Upon presentation of a stock certificate, for example, with warrants attached and an amount sufficient to pay for the stock purchasable with the warrants, the holder may receive, in addition to the newly acquired stock, a new certificate for the shares without warrants, or the same certificate with the warrants detached. Should the holder of a certificate with non-detachable warrants want to exercise the option to purchase less than all the shares purchasable under his warrant, he may, under provisions generally made in the warrant instrument, present his certificate with the warrant attached to the transfer office of the corporation and get two or more certificates aggregating the number of shares presented with warrants attached thereto. This rearrangement of certificates permits him to present warrants entitling him to purchase such an amount of shares as he desires. Frequently, warrants are instruments entirely distinct and apart from the stock certificate.

Limitation of stock purchase privilege.—Stock purchase warrants may be, and usually are, limited in time, as in the case of conversion rights, or they may be scaled to permit the exercise of the warrant at a certain price during one period and at increasingly higher prices during later periods. For example, Distillers Corp.-Seagrams, Ltd., issued warrants entitling each preferred shareholder to purchase one share of common stock for each share of preferred at any time up to April 30, 1938, inclusive, at $28 per share; thereafter up to October 31, 1939, inclusive, at $30 per share; thereafter up to October 31, 1941, inclusive, at $32 per share. Warrants were not exercisable separately from the stock prior to May 1, 1938. The warrants are void after October 31, 1941.[35]

[35] The stock purchase warrants of the Associated Telephone Utilities Company expired during a period of business and stock market depression before they had had a chance to become valuable. The corporation therefore extended the period of the warrant one year.

The period may be based upon the number of shares presented instead of upon time. For example, Class "A" shares of the Dinkler Hotel Co., Inc., were issued with detachable warrants entitling the holders to purchase the equivalent amount of common at $15 per share in case of warrants on the first 10,000 shares presented, at $18 per share on the second 10,000 shares, and at $24 on the remaining 10,000 shares.

The effect of making the purchase price higher as time goes on is to hasten the exercise of the privilege. Limiting the period during which the warrants are valid is intended to prevent dilution of the securities after they have become seasoned

Purchase and sale of warrants.—Detachable warrants, or separate stock purchase warrants, may be bought and sold in the market. So long as the market price of the stock purchasable with the warrant is higher than the warrant price, the warrant has a definite exercise value. The warrant may be worth more than the actual difference between the market price of the stock and the exercise price, for it may have a value added to it by the prospect of its becoming more valuable. Warrants may also have a value at a time when there is no difference between the market price of the stock purchasable with the warrant and the warrant price. For example, the Alleghany Corporation has outstanding a 5½ per cent cumulative preferred stock with warrants permitting the purchase of common stock at $30 a share. The price of the stock with warrants was quoted at the end of October, 1929, at around $103 a share and the stock ex-warrants was selling at the same time at around $90 per share The common stock quotation at the same time was about $30 a share, or exactly the price at which the stock could be obtained upon exercise of the warrant. This would indicate that the warrant had a speculative value of $13.

Trading in warrants was popular during the stock market boom of the late twenties, because it permitted holders to make a profit through rises in the value of stock, without tying up more capital than was represented by the cost of the warrant.

The stock purchase warrant may be used by one engaged in a short sale of stock to protect himself against heavy losses. If the stock sold short fails to move down as expected, but rises instead, the holder of the warrant can always obtain

the stock by exercising the warrant and paying the subscription price.[36]

The New York Stock Exchange rule governing transactions in securities having subscription warrants attached is that such transactions, except those made specifically for cash, shall be ex-warrant on the full business day preceding the date of expiration of the warrants, except that when the date of expiration occurs on a holiday or half-holiday, such transactions are ex-warrants on the second full business day preceding the date of expiration.[37]

Dilution, change, or destruction of stock purchase warrants.—The same changes in financial structure that dilute, change, or destroy the conversion privilege will affect similarly the rights and interests of the holders of stock purchase warrants. To protect the holder of the warrant against an impairment of his interest, the instruments creating the stock purchase warrant usually make provision similar to that described with respect to convertible stock on page 146.

As in the case of convertible stock, an additional issue of shares purchasable with the warrants, or a sale of such shares at a price lower than the subscription price to the warrant holder, will reduce the value of the stock purchase warrant. The usual protection against such changes is an adjustment of the price to be paid for the stock as well as of the number of shares purchasable. A redemption of the stock to which the warrants are attached would destroy the warrant. To protect the holders of such warrants, many corporations have provided that if the stock is redeemed on or before a certain date the holders of unexercised warrants will be entitled to exercise the warrants up to a certain later period. Such a provision was found in the warrants attaching to the preferred stock of the Mangel Stores Corporation. Or the protection may consist in issuing a similar detached warrant if the stock is redeemed before the warrant is exercised. In other words, the warrant does not cease with the redemption of the security with which it was originally issued. See page 257 for illustrations of other treatments of stock purchase

[36] See page 219 for an explanation of short sales of stock. See Stock Exchange Practices, Report No. 1455, 73d Congress, 2d Session, p. 51, for examples of profits made by short selling against options.

[37] Any warrants traded in on a national securities exchange, which are not exempt under the rules of the Securities and Exchange Commission, must be registered with the exchange on which they are traded, under the provisions of the Securities Exchange Act of 1934.

warrants in case of redemption of the securities with which they were originally issued.

Disadvantages of stock purchase warrants.—The use of stock purchase warrants is a comparatively new form of financing, all the legal incidents of which have not yet been worked out. It is incumbent upon the corporation, in the issuance of stock purchase warrants, to consider how the rights of the privilege holders and of the shareholders will be affected by the use of warrants, and to protect those rights. If the corporation does not act with circumspection, it may find itself involved in legal battles and subject to liabilities for damages.

Since the exercise of the stock purchase warrant is at the option of the holder of the stock, the corporation may be furnished with cash at any time whether it is in need of cash or not Usually the warrant is exercised when the company is most prosperous, and therefore when it is least in need of additional capital.

The use of the stock purchase warrant ties up a certain amount of unissued common stock for an indefinite period and prevents the issuance of that amount of stock at one time for a lump amount of new capital when needed. On the other hand, corporations that are growing and that are regularly in need of capital may find the stock purchase warrant an excellent device for obtaining capital to meet a growing capital requirement.

If the corporation is successful, the price fixed in the stock purchase warrant may become much lower than the ascending value of the stock purchasable with the warrant. This leads to the disadvantage that those holding the shares purchasable with the stock warrants will find the book value of their shares, as well as their participation in the earnings, constantly subject to dilution. For example, suppose the corporation has outstanding 10,000 shares and its balance sheet is as follows:

Assets	$2,000,000	Capital stock (10,000 shares, par value of $100 each) . .	$1,000,000
		Liabilities	500,000
		Surplus.	500,000
	$2,000,000		$2,000,000

Each share has a book value of $150 Suppose the corporation has outstanding warrants entitling the holders to purchase

5,000 shares at $110; we must assume that at the time this warrant price was fixed $110 represented substantially more than the book value of the stock at that time. Suppose now that all the option holders exercise their options The result will be the following balance sheet.

Assets	$2,550,000	Capital stock (15,000 shares, par value of $100 each)	$1,500,000
		Paid-in Surplus	50,000
		Surplus	500,000
		Liabilities	500,000
	$2,550,000		$2,550,000

The book value of each share has fallen to $136 66⅔, and all future profits must be divided among 15,000 shares. Unless the corporation makes public the amount of options or stock purchase warrants outstanding, investors cannot tell to what extent this dilution is likely to take place. For this reason, the registration statement required to be filed under the Securities Act of 1933 before securities can be publicly offered for sale calls for complete information as to options outstanding or to be created in connection with the issue covered by the registration. Similarly, information as to options outstanding or to be created is required in connection with the registration of securities on a national securities exchange, under the Securities Exchange Act of 1934. (See page 369.)

Where the stock purchasable with the warrants has voting power, exercise of the privilege may affect the voting control of the company.

General rights of preferred stock.—Having described the classes of stock that are usually found in a corporation, we may now inquire into the rights which a preferred stockholder has in the absence of a special contract. Suppose, for example, that a certificate of incorporation provides that the stock of the company shall be divided into two classes, 7 per cent preferred, and common. What are the rights of the holders of the preferred stock? The general rule is that in the absence of a special contract the preferred has all the rights of the common. Hence the preferred would be voting, not preferred as to assets, not redeemable, nor convertible, nor protected. Some courts say that it would be participating; others that it would not. The apparent exception to the rule is that in most States the preferred stock will be deemed to be cumulative and not non-cumulative.

Other classes of stock.—Certain terms which are used to describe shares of stock may be briefly referred to here.

Prior preference.—Sometimes, after preferred stock has been issued, another stock, which in effect is a first preferred but which is called prior preferred, may be issued with the consent of all the stockholders. Pere Marquette Railway Co. gave the name of prior preference stock to a class of stock in its reorganization of 1917. See also prior preferred stock of the Market Street Railway Co, of San Francisco. A classification of preferred stock in order of priority also gives rise to the titles "first preferred" and "second preferred." The title of a stock does not necessarily show its rank, the choice of name frequently having been determined by popular designations at the time the issue was created.

Deferred stock is stock on which dividends are to be deferred until payment has been made on another class. It is usually created in connection with some form of readjustment of the capitalization.

Guaranteed stock is a term sometimes used as a synonym for preferred stock, but when so employed is a misnomer, for a company cannot "guarantee" dividends on its own stock. The title is correctly used when applied to a stock, the dividends on which are guaranteed by another corporation For example, a parent company may guarantee dividends on the stock of a subsidiary, and in that event the guarantee amounts to a debt owed by the parent company to the stockholders of the subsidiary, conditioned on the failure of the subsidiary to pay its own dividends.[38] Examples of guaranteed stock in American finance are numerous. The Atlantic Coast Line, for example, guarantees dividends on the 5 per cent cumulative preferred stock of the Atlanta, Birmingham and Coast R. R.

Special stock is very much like debentures, issued under the terms of a special statute of Massachusetts. Dividends on this stock are a debt of the company and all the general stockholders are liable personally for all debts and contracts of the company until the special stock is fully redeemed. It is not used now, so far as we can ascertain

Debenture stock is an English term. It really does not indicate a share of stock at all, but means a bond; if the term

[38] See Windmuller v Standard, etc, Co., (1906) 105 N. Y. App. Div. 246, affirmed without opinion in 186 N Y. 572

is used in this country it is generally used to indicate what is usually termed debenture bonds. It is most frequently used in connection with government finance [39]

Founders' or management shares are more frequently used in foreign than in American corporations. Generally they answer to the definition already given of deferred stock, though the term is sometimes applied to shares of stock the holders of which have contracts essentially different from those of the holders of deferred stock. Founders' shares are usually issued in smaller amounts than other classes of stock, and generally carry dividend provisions that encourage the directors or founders, who are the holders of such shares, to increase the earnings of the corporation.[40] Frequently, they are the only class of stock with voting power, but provision is made that other classes of stock shall share the voting power with the founders' stock if dividends on such other stock are not paid. Thus, the holders of the founders' stock of the New York Shipbuilding Corporation have exclusive voting power unless dividends are in arrears for one year on the 7 per cent cumulative preferred, when preferred shares have equal voting power with the founders' shares.

Founders' shares would be better named if they were called management shares, as they were by the Fisk Rubber Co., which had a small amount of such stock outstanding prior to its reorganization in 1933. Charles E. Hires Co has issued a nominal amount of management shares, all of which are held by the Hires family, which has the exclusive right to elect directors up to December 31, 1960, provided dividends of $4 per share are not in arrears on Class "A" stock, in which event all shares have equal voting power until the default is corrected.

The Goodyear Tire & Rubber Co. issued in its reorganization of 1921 a nominal amount of management stock to a group of people representing the bondholders Bankers who

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[39] Sometimes the term debenture stock is used in American companies to indicate a special kind of preferred stock See, for example, the debenture shares of the Sunray Oil Corp

[40] The American Brown Boveri Electric Corporation has outstanding an issue of 7 per cent cumulative preferred stock, an issue of participating stock, and founders' stock After January 1, 1929, the participating stock is entitled to 65 per cent of the net earnings after preferred dividends, and the founders' shares are entitled to 35 per cent of the net earnings

held this small block of stock had sole voting power so long as any of the first mortgage bonds sold were outstanding.[41]

Sometimes the objective of concentrating control in the hands of a small group is attained by a voting trust, but the management stock has the advantage of not requiring stockholders to turn in their certificates in exchange for voting trust certificates[42] The trend in recent years, however, has been away from shares which concentrate control in the hands of a small group of managers or bankers. See a discussion of this subject on page 107.

Bankers' shares—In 1919 the Cities Service Company, a well-known public utility and oil holding company, deposited 30,000 shares of common stock with a trust company, and the latter issued against these 300,000 "bankers' shares." These so-called shares are merely non-voting certificates of beneficial interest in the stock of the company and are exchangeable, ten bankers' shares for one common share This device permits the company to sell its stock in small units without reducing the par value.

The term "bankers' shares" is also applied to the class of stock which has sole voting power and which is held by a small group, generally the organizers of the corporation and the bankers who financed the issues. It would thus be the same kind of stock as the "management shares" described above.

Promoters' stock.—This term is applied to stock given to promoters in part or full payment for services rendered Promoters' stock is similar to bankers' and management shares described above, though it frequently does not have voting power The provisions of the stock make it possible for the holders to obtain large profits if the enterprise is successful.

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[41] In 1927, a recapitalization plan was adopted which included among other changes in the capital structure the cancellation of the management stock

[42] See also page 690 for the use of a subsidiary to give the management a special interest in the earnings

CHAPTER IX

COMPARISON OF FORMS OF ORGANIZATION

Ease of organization.—Having described all the forms of business organization briefly, and the most important one, the corporation, in detail, we may now compare them with respect to important questions that are likely to arise when a new business is to be formed or when an old one is to be reorganized. In any given case the ultimate choice must depend largely on the peculiar circumstances of the business or the objects which the organizers have in mind. Perhaps the first question that will arise is: how difficult is it to organize the several forms of business association?

The simplest form of organization is the sole proprietorship. But where more than one person is to own the enterprise, choice must be made among the other forms. Because the business is likely, if a new one, to be small, the elements of ease and economy of organization may be the determining factors. Partners may get together with a simple agreement to contribute definite sums and to divide the profits and losses in certain proportions. The law will infer all the rest, and the terms thus inferred, it should be added, will be in most cases very satisfactory. A syndicate may be, and very frequently is, organized in the same simple way. But the agreement of the limited partnership must comply so closely with the provisions of the law—else a general partnership will result—that the organization of this form of agreement is best left to the experienced lawyer. The same may be said of the Massachusetts trust, the joint stock company, and the corporation. However, the methods of forming corporations are so fully explained in legal texts that we would not put the corporation lower down in the scale of forms of organization than, say, the joint stock company or the limited partnership, and certainly on the score of ease of organization we would place it above the Massachusetts trust. The trouble with this latter form of association is that it is likely to run against some local rules, statutory or common law, bearing on the relation of trustee to *cestui*, or on the management of the

trust, or on the liability of the parties The rules stated in the text preceding are only very general; before one attempts to organize a trust in any given State one ought to familiarize oneself thoroughly with the law of trusts in that jurisdiction.

Freedom of movement.—The right to move about is not very important for some concerns, as, for example, a retail establishment with a single place of business, or a manufacturing concern with one plant, the product of which is sold locally or distributed through a single independent agency. But where, as is so frequently the case, branches are to be established and agents sent out, the choice of a form of business ownership must take into consideration this problem of the right of the business to move about with little special interference

Within the United States, on account of the constitutional provision that "the Citizens of each State shall be entitled to all Privileges and Immunities of Citizens in the several States," those forms of organization which do not in any sense create an artificial entity have an advantage. If, for example, *A* is a citizen of Illinois and wishes to carry on the business of selling textiles in New York, he may do so in that or any other State of the Union without paying any greater taxes or incurring other obligations greater than those imposed on the citizens of those States. To be sure, the selling of textiles in some States may for special reasons be considered to so affect the health, welfare, or morals of the people as to make it expedient to permit only licensed persons to carry on the business. But even in those States, *A* would not have to pay any greater license fee than a resident.

In foreign countries special rules against alien ownership of land or control of business may make it advisable to form a local corporation.

A limited partnership must, in each State and each country where it does business, comply with the local rules applicable thereto. A general partnership, however, may generally be regarded as a simple collection of individuals and may move about as an individual might. And the same is true of a syndicate. Joint stock companies are entitled to the constitutional protection intended for citizens and cannot be placed under unusual burdens.[1]

[1] "In a Minnesota case, State v United States Exp Co, 81 Minn 87, a statutory joint stock company (express company) organized in New York but

The corporation is not a citizen and hence may be kept out of any State in the United States, or may be admitted only on compliance with special conditions. Because each State will want its corporations to enjoy freedom of action in other jurisdictions, it will ordinarily permit foreign corporations to come within its own borders. Usually, however, the foreign corporation will have to file certain papers showing the scope of its activities and designating a responsible local agent, it will also have to supply data from which an entrance tax can be levied and subsequently will have to submit annual reports from which the annual license tax can be computed. The local laws must be consulted in each case.[2]

Special mention must be made here of the doctrine of interstate commerce. When the States formed the Union, they gave to Congress the power to regulate interstate commerce. With few minor exceptions, this power is now held to be exclusively committed to Congress, and the States are not permitted to interfere.[3] If, therefore, a corporation does business from its home State *into* other States, for example by sending a salesman through it to take orders to be filled by shipments from the home State, those States will not be permitted to exclude the corporation on any terms. This rule results from the State's inability to interfere with the right of Congress to regulate interstate commerce. But if the com-

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not incorporated so as to be a corporation, was sought to be examined as to its business by the Minnesota Railroad and Warehouse Commission, but it refused to answer as to its business and property outside the state and as to its interstate business. The Supreme Court of Minnesota held that 'the defendant not being a corporation, but a partnership, has the same right to do business in this state without its permission, and free from its control and visitorial power, as any other individual or partnership,' and that while questions as to its property within the state were proper on the theory that it was a common carrier whose business was affected with a public interest and therefore subject to public control and regulation, yet information could not be demanded as to its property outside the state or its interstate business The court said that 'if it were a corporation, domestic or foreign, the state, by its authorized officers, would have the undoubted right to require full information as to all of its business; for the state has the right to know what its creature, or one of another sovereignty that it permits to come into the state, is doing. If, however, it be not a corporation endowed by law with special franchises and rights, but a partnership existing by virtue of the contract of its members, then the state possesses none of the visitorial powers which it may exercise over corporations'" W. M Fletcher, "Cyclopedia of the Law of Private Corporations," First Edition, page 10,517.

[2] See Prentice-Hall State Tax Service

[3] The exceptions are too immaterial to mention here.

pany attempts to do business *inside* the State, for example by establishing a local branch there, it will to that extent be engaged in *intra-* as distinguished from *inter*-state business, and the State may establish conditions on which the business may be so conducted.[4] The tendency seems to be for Massachusetts trusts to be regarded as corporations when entering the States to do business therein. Formerly, the trustees of a Massachusetts trust were considered able to do business in any State on the same terms as local trustees, but even under that rule it was necessary for the trustees to pay attention to local rules governing the relation of trustees to *cestuis* and to third persons, for intricate questions of conflict of laws were likely to arise.

Liability of owners.—One of the chief questions that will determine the selection of the form of business organization is that of liability of the owners. We discussed the problems involved here quite fully in describing the several types of organization. It is only necessary to add that the great advantage of the corporation in providing limited liability for its members accounts for the prevalence of that form of organization.

Functionalization of management.—While a business is small, the individual proprietorship has great advantages in the case with which duties and powers may be delegated The proprietor may constitute that form of government which political scientists in the past generally agreed was the best theoretical form of political government, namely, benevolent despotism. The proprietor may delegate various powers to various agents, and so long as he does not clothe them with the appearance of general agents they will have only such powers as are delegated to them. Moreover, the proprietor himself forms the single co-ordinating force. When the business grows, he will need intermediary co-ordinating elements, such as written reports and analysts to interpret, combine, and condense these reports. Then gradually he will have to build up a personnel of subordinates of various ranks to communicate and supervise the carrying out of his orders.

When the business gets to this size the principle of standardization will begin to operate. The operations will become

[4] International Text Book Co. v. Pigg, (1909) 217 U. S 91, is the leading case on this point.

so complicated that wherever possible they will have to be standardized, and the elementary units of the business will get farther away from the proprietor. But all the same, questions of policy will become more important, and these usually are best attended to by one who has directed the concern and knows its traditions and history. For this reason, even large successful corporations commonly elect the same chief executive year after year The United States Steel Corporation, for example, retained Elbert H. Gary as chairman of the board of directors from the time of its organization in 1901 until his death in 1927, and changed its president but three times during the same period

In no respect does the general partnership fall short more decidedly than in the matter of susceptibility to scientific organization Because each partner is a general agent, it is difficult to tie the partners down to definite tasks. Let us imagine a situation. A partnership of three persons wishes to give one the exclusive selling power, another the power to purchase, and the third the power to produce. They make a written agreement embodying these ideas This will be binding only on persons who know the terms of the agreement. For example, if the selling partner buys goods useful for the partnership from a person who does not know that the various functions have been distributed among the partners, this third person may hold the partnership liable for the contract price. Filing the agreement in a public office ordinarily will not be of any help, for such instruments are not required to be filed and third persons therefore would not have constructive notice of their contents. To be sure, the offending partner in this case may be held to account for breach of his contract, but in practice the partnership will usually have to dissolve when the partners begin to enforce legal remedies against one another.[5]

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[5] An example of what might be done toward functionalizing a partnership was afforded by the Baldwin Locomotive Works. Mr Alba Johnson, who for a number of years has been the head of the Baldwin Locomotive Works in Philadelphia, stated in a lecture at the Wharton School of Finance and Commerce, University of Pennsylvania, before his company was incorporated: "The business organization [of the Baldwin Locomotive Works] is more simple and compact than any business organization which I know of, conducting a business of equal magnitude. There are theoretically six partners Actually, at present, three of those partners are seniors who do very little in the actual drudgery of the business. Theoretically, we have one partner in charge of finance, one partner in charge of the business—that is, the business

In a limited partnership the special partners must exercise no control, but if the general partners try to apportion the management they will run into the same difficulties that the general partnership experiences. The Baldwin Locomotive Works, we saw, was not so long ago a partnership and the partners carefully carried out their prescribed powers and no others. But they had grown up in the business and had learned their special functions, and what was more, had learned to respect in their fellow partners peculiar capacities to settle the affairs of their own departments.

The joint stock company and the corporation may easily functionalize the management, as we have seen, through the appointment of several officers to take care of various duties. Thus everybody would know, and would be bound by his knowledge, that a "vice-president in charge of sales" has no right to do the purchasing for a corporation.

In business trusts the duties and powers of the trustees are governed by the provisions of the instrument creating the trust. In the absence of specific provision the general rule

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of buying and selling, making contracts, managing the office (the thousand and one things necessary for the conduct of any business)—one partner in charge of design, who is the chief engineer, and one partner in charge of the works, who is the general superintendent or the general manager. We have not any of those titles. As a matter of fact there are no such offices. We are all partners on an equality and we handle the business in each department simply on the basis of an agreement that that shall be the business organization. As a firm we hold meetings (according to our co-partnership articles, every week, but actually whenever we find it necessary to do so) at which all matters of broad business policy are discussed—matters of establishing new works, putting up new shops, or making large expenditures for tools. We agree upon such questions in firm meeting. We agree on large policies in regard to making sales, rearrangements of expense, etc., but each of these four partners is absolute autocrat of the branch of business he represents, because he knows all the time what the attitude of his partners is toward these matters. He does not have to consult them to decide whether it is necessary to make a contract or not. The thousand and one questions which are coming up daily in the administration of the business are settled instantly by the partner to whose province they belong, and if it is necessary to consult or get the opinion of one of the other partners, it can be done in an instant. That is a great contrast to the corporate form of organization, in which the Board of Directors, by the President, and in which the Secretary, Treasurer, and General Manager each has his little province, and they are all apt to be more or less jealous of each other, because I do not know of any place where the jealousies are apt to be keener than they are in business corporations, where the intrigue for promotion is apt to be very great. . . ."

In later years when the Baldwin company needed funds for expansion, it was incorporated, the incorporation being a tribute to the ability of corporations to aggregate large sums of capital.

is that the trustees must co-operate. But this merely means that all the trustees must be permitted to be heard. It does not mean that every decision must be unanimous, for when all have been given an opportunity to be heard, a majority will govern. If the deed of trust is properly drawn it will provide either directly for a division of powers amongst the trustees, or will permit the trustees to organize themselves on the functional plan. Thus it will be seen that as far as management is concerned, the business trust may be made very flexible.

The joint adventure or syndicate is usually managed by one person, who appoints employee agents. This form of organization, therefore, is from this standpoint comparable to the individual proprietorship.

Flexibility in apportioning income, control, and risk.—We now come to a very intricate problem, and one the full discussion of which would lead us into the anticipation of questions that must be reserved for later chapters. But the problem is an important part of the whole question of the correct selection of the most appropriate form of business enterprise.

We must begin with some elementary ideas. Hastings Lyon, in his admirable little book "Capitalization," developed the idea that the interests in a business enterprise have three basic factors to deal with: first, how shall the control be apportioned, second, how shall the income be apportioned; and third, how shall the risk of losing the investment and, if necessary, that of standing for the losses out of the owners' independent means, be divided? These questions may seem easy, but one who is at all familiar with the subject will recognize their complexity. The problem, it will be seen, is not merely whether these three elements may be separated from one another, but also whether each may be divided and whether the component parts of each element may be apportioned.

Control.—Take control, for example. But first let us ask: is the right to exercise control important? It seems unnecessary here to go into such philosophic discussion as Thorstein Veblen essayed in his "Theory of Business Enterprise," but we may ask the reader to try to imagine for himself the power which control of a business gives. We have known of officers of a corporation using the employees of the company for various personal duties; to mention cases that have got into the

daily press would probably serve merely to emphasize these particular occasions, whereas our observation tells us that the practice is quite universal and varies only in degree. And the joke of it is that the person who most objects to the practice probably follows it himself in another form in his official capacity of labor leader, college professor, head gardener, or simply woodchopper.

In the sole proprietorship, ultimate control is all concentrated. In the general and limited partnerships, excluding in the latter case the special partners who have no control, the voice of the business rests in all the partners and it is difficult to apportion the various functions.

In the syndicate or joint adventure, the control may in practice be divided. The manager may do business for the venture in his own name and the other owners may appear simply as his agents to carry out the powers he delegates. In the joint stock company and the corporation, the control may be almost entirely divorced from the other elements of ownership or may be distributed among the owners on various plans. For example, in the corporation in some States the directors need not be stockholders, and in other States the number of shares they need to hold is usually so small that the ownership is practically nominal. Other methods of apportioning control have been described. In the Massachusetts trust the stockholders cannot exercise control; if they do, they turn the enterprise into a partnership.

Apportioning income.—In all forms of association the apportioning of the income may be made very flexible. In the sole proprietorship the sole owner, of course, gets all the profits after payment of obligations due to creditors. In the other forms the owners may agree that income shall be divided in amounts, and that certain owners may get stipulated amounts even if the others have to go entirely without income in poor times. As far as the corporation is concerned, these methods of apportioning income are in practice almost infinite in number. The Massachusetts trust may issue the various forms of preference shares employed by corporations to apportion income. The partnership may use all the corporate devices of preferences, and so forth, not by issuing shares, but by incorporating the preferences into the partnership agreement; but in practice this has not generally been done. The same might be said of the other forms of business.

Risk.—Two classes of persons are interested in every business, the owners and the creditors.[6] The owners are the risk-takers. In every form of business the assets of the business must go to the creditors before the owners can withdraw even their capital. To be sure, even the creditors have their order of priority, but this question we shall defer till later. But the problem always arises: if the common property cannot satisfy the creditors, will the owners have to contribute out of their individual means and, if so, to what extent, and in what order? The principal questions here involved were discussed when we described the various forms of business. The sole proprietor risks everything, as do the general partners. The special partners and the stockholders risk only the amounts they have agreed to invest.[7] Members of a syndicate and members of a joint stock company take the same risks as partners.

Just as the creditors take the property of the business, class by class—that is, for example, all taxes must ordinarily be paid off one hundred cents on the dollar before other debts are paid—so the owners, if anything is left after debts are satisfied, may share the property in a predetermined order of priority. The law says generally that they take back their contributions proportionately, but they may agree to do otherwise. For example, in corporations we have "stock preferred as to assets." (See page 140.) And so in a partnership the partners may agree that after all debts are paid off, the remaining property shall be divided as follows: (and then any arrangement may be worked out). What is more, while partners are each liable for the debts of the partnership, they may agree among themselves to apportion this risk on some definite predetermined basis. The weakness of this plan, which seems to permit of so much flexibility, is that it is not binding on the creditors. The latter may collect as they see fit and then if the partners are not able to stand the losses as they have agreed to, the affluent partners will suffer.[8]

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[6] A third class, indeed, are just as deeply interested, namely, the employees. We omit them here simply because their relationship is ordinarily considered in treatises on management

[7] In most States, stockholders, by statute, are liable to unpaid creditors of an insolvent corporation for the difference between the par value of their stock, or in the case of non-par stock, the amount agreed to be paid, and the amount paid thereon They may also be made liable for wages.

[8] These rules, of course, may be varied by agreement with the creditors. An agreement among the members will not be sufficient Creditors, however,

Relation of risk to control.—Sometimes the question arises is a person interested in a partnership really one of the partners, or is he a creditor; or, if the concern is incorporated, is he a stockholder or a bondholder? In the latter case, for example, he may hold a document purporting to be a bond, but the court may construe the instrument to be a share of stock. Generally the test is. has the holder any control? If so, he is an owner and must take the owner's risk. He cannot exercise control and at the same time step in with his claim as that of a creditor. He cannot eat his cake and have it. As we have seen, in a corporation this can only be done indirectly through a voting trust.[9]

So, too, in a partnership, if a person purports to lend money, his loan will be construed as an investment if he appropriates the right of a voice in the business

Stability.—We have seen that the sole proprietorship and partnerships are quite unstable. The reader must differentiate between "stability" and "durability" when considering the other forms of organization One form of organization may not easily be disrupted—it has stability or "continuous succession"—whereas under the law of the State where it is organized it may not be permitted to be formed for an unlimited period. In some States, Arizona and Iowa, for example,[10] corporations may not be organized for longer than a given number of years. They have "stability" or "continuous succession," in that they are not disrupted by the death of a member, but they have not unlimited durability. The Massachusetts trust, we saw (page 63), is usually of limited duration; the joint stock company and usually the corporation have unlimited duration, while the joint stock company, the Massachusetts trust, and the corporation have transferable shares and therefore enjoy stability or continuous succession. They are not affected by the death, insanity, or bankruptcy of the members.

Freedom from governmental control.—This is not the place to go into a discussion appropriate for political science or political economy. But the relation of these subjects to

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will be held to acquiesce in members' agreements where they know the terms of the agreement and thereafter deal with the concern

[9] See page 117, and see for an example, C W. Gerstenberg, "Materials of Corporation Finance," page 940.

[10] See table, page 85.

our immediate inquiry is very intimate. At one time business was regulated chiefly because it contained abuses. That was the "thou shalt not" stage Now government is regulating business largely for a positive social purpose, not only taking property from business for largely increased public operations by means of taxes, but telling business what service it shall render, and how much it shall charge. Regulation depends not so much upon the form of organization as upon other factors. For example, on the whole, large businesses are much more burdened than are small ones, irrespective of form of organization. Certain businesses—those affected with a so-called public interest—are more completely regulated than those deemed private. The fact is, however, that the courts have almost entirely abandoned the right to review the legislatures in the matter of classification of businesses for purposes of control, and today almost any business is affected with a public interest if the legislature so determines.

But there are certain government interferences that are based on the classification of businesses according to form of ownership. Corporations, for example, are required to prepare reports in every State within which they do business. They pay taxes for the privilege of being a corporation and doing business as such in the several States. The tendency is to treat joint stock companies and Massachusetts trusts in the same way. For example, the tax law in New York State classifies trusts with corporations. Limited partnerships, being creatures of the State, likewise may be discriminated against. The burden that might be placed on them would simply be the price of the privilege of limited liability. It should be said, however, that in practice, limited partnerships, for this purpose, are generally classed with general partnerships. The sole proprietorship and the general partnership have the greatest freedom.

Legal status of business forms.—But there is another phase of the question that we shall do well to consider here, namely, the legal status of the various forms of business. The status of the individual proprietorship and of the general partnership is well established by a long line of court precedents touching on every conceivable phase of the relationship. These long-established rules have been codified for the partnership in a uniform partnership law, and they have not been modified by statutes in the various States. Hence the law

of partnerships is quite uniform wherever the common law prevails. When you deal with a partnership or on behalf of a partnership, you know what to expect when contingencies arise.

On the other hand, corporations are governed very little by court precedents, but by statutes These statutes have developed along very different lines in the several jurisdictions and even the best corporation lawyers can hardly hope to remember the detailed rules of more than one or two States.[11] Whenever a situation arises that is governed by the rules of another State, the latter's statutes and the decisions thereunder must carefully be consulted. Even this difficulty is aggravated oftentimes by the fact that the statutes of a State are carelessly worded and have not been interpreted by the courts. It is for this reason that most corporations are organized in a few States only. The laws of these States have been amply interpreted and we know when we form corporations there what all the relations involved in the corporation are.

The reason for some of this confusion in corporate laws is that States, in passing laws, have had two objects in mind first, to get the corporation within the State in order to collect the taxes it will yield, and second, to regulate it because it is a "soulless" institution. A good example of the struggle between these conflicting aims was the passage of the so-called "Seven Sisters Acts" in New Jersey under the reform administration of Governor Woodrow Wilson, the subsequent realization that these laws were costing the State revenue, and their consequent gradual repeal.

Massachusetts trusts are meeting with trouble because of diversity of laws. Lawyers would hardly recommend this form of organization where the enterprise is to carry on an active business in a number of jurisdictions.[12]

Conduct of business according to legally prescribed forms. Another burden of governmental regulation is the prescription of the method of conduct. The general partnership, for example, can go on its way entirely free. On the other hand, the limited partnership must carefully follow the rule as to omitting the names of special partners from the firm name,

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[11] See table, pages 82–89

[12] See a series of articles by Prof. Ira P. Hildebrand in the *Texas Law Review*, beginning February, 1923.

and must list the special partners' names on the outside of the principal office. A Massachusetts trust would probably get into all sorts of difficulties if it did not always couple its name with a designation of its trust form of organization. The corporation is made subject to a great many rules, many of them logical and others quite peculiar. (See, for example, matters that must be ratified by stockholders, page 102.) Whether logical or peculiar, the statute governs, subject only to the rule that constitutional rights must not be invaded The result in the case of the corporation doing an extensive business is that knowledge of the general principles of corporation law is not enough, it is necessary to know the exact meaning of the particular statute.

Laws regulating issuance of securities.—From the standpoint of Federal regulation of the issuance of securities, all the forms of business organizations that we have discussed are treated alike. All must conform with the Securities Act of 1933, which requires the registration of securities that are to be offered publicly through the channels of interstate commerce and that are not exempt. (See page 358) However, since individual proprietorships and partnerships rarely finance their enterprises through public offerings of stocks, bonds, notes, and other securities, the law is principally regulatory of corporations, joint stock companies, and Massachusetts trusts.

The State blue-sky laws, discussed more fully on page 356, are another example of regulation. Individual proprietorships and partnerships have an advantage from the standpoint of these laws; they may, without interference, take in new partners and induce people to become creditors, but businesses that issue stock and other securities have to comply, as do the offerers of their stock, with the provisions of these blue-sky laws in every State where securities are issued and such laws exist.

Selection affected by nature of business.—The inherent characteristics of the several forms of business association make some of them more suitable than others for certain kinds of business. For example, public utilities, such as railroads, telephones, and gas works, involve such large properties and demand such uninterrupted service that the individual or partnership form of organization would hardly be suitable. They need the continuous succession charac-

teristic of the corporation. On the other hand, where personal service is important the corporation is too impersonal Indeed, in many States certain forms of business may not be incorporated because the law insists upon the client and customer coming into direct relationship with the person who should assume professional responsibility. In New York, for example, corporations may not practice medicine, or dentistry, or law. The New York Stock Exchange on the same principle insists that its members be unincorporated.

Taxation.—But the most onerous form of government interference in these days is taxes. This interference takes three forms. first, the preparation of returns, second, submission to inspection; and third, actual payment of the taxes.

In its annual report to stockholders for 1937, the Foster Wheeler Corporation included a statement that during that year the Corporation filed approximately 5,590 separate reports to the Federal Government and 1,760 different reports to State governments. The annual report indicated that the number would be increased during 1938

Some people have the erroneous idea that the Federal income tax covers the whole tax program There are other Federal taxes to be paid, such as the capital stock tax, the excess profits tax, the old age benefits tax, and the unemployment insurance tax. There are also many State taxes to which a business may be subject, such as franchise and license taxes,[13] unemployment insurance taxes, State and local occupational taxes, and local property taxes Then, of course, there are the Federal and State stamp taxes While the corporation does not pay any Federal estate tax or State inheritance and estate taxes, it may be concerned with such taxes in connection with the transfer of securities of the corporation by those who represent the deceased stockholder.

Almost every law imposing these taxes gives some official the right to call for books and documents on a moment's notice. For example, we have known of many instances where State inspectors have called on New York corporations and have asked to see the stock transfer books to ascertain whether the proper stamps have been affixed to meet stock transfer requirements.

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[13] For a comparison of these, see page 83.

Corporations, and perhaps joint stock companies and trusts, have undoubtedly been subject to a greater assortment of taxes than other forms of organization. The State franchise and license taxes are reserved for these forms, so also are the Federal capital stock tax and the Federal excess profits tax[14] We have yet to learn of any form of tax placed on natural persons or partnerships that is not at the same time assessed to corporations

Besides being subjected to special taxes, corporations often suffer from discrimination in the imposition of a given tax We may throw some light on this subject if we examine the different forms of business association in the light of the unemployment insurance taxes and the Federal income tax[15]

Selection of organization in the light of unemployment insurance and old-age benefits taxes.—In respect to State and Federal unemployment tax laws and the Federal old-age benefits law (Federal Insurance Contributions Act), there may be a decided tax advantage enjoyed by the individual proprietorship and partnership over corporations, which include, for purposes of this law, joint stock companies, Massachusetts trusts, and other associations. To understand the advantage, it is necessary to understand the tax provisions of the laws.

The State unemployment insurance laws are imposed upon employers of a certain number of individuals. In a majority of the States that number is eight or more; in a few States the number is one or more. In determining whether the employer is subject to the Act, officers of corporations are counted; whereas individual proprietors and partners are not counted The effect of this is extremely important. Assume the *A-B* partnership has six employees in a State which makes employers of eight or more individuals liable to the tax. Since, in determining liability, *A* and *B* are not counted, the partnership would be under no obligation to pay the State unemployment insurance tax or to file reports. Assume that *A* and *B* had incorporated their business and that they were the president and secretary, respectively, of the organization. They would be counted as employees, and the corporation would pay unemployment insurance taxes on the compensation of officers as well as of employees.

[14] See discussion of these taxes on page 178.

[15] For a complete discussion of Federal taxes, see the current year's edition of the Prentice-Hall Federal Tax Service

Since the State rates are generally 2.7 per cent of the *total* annual remuneration of employees, it is obvious that the State unemployment insurance tax constitutes an appreciable cost of doing business.[16]

The Federal unemployment insurance tax imposed by the Social Security Act is levied upon employers of eight or more persons. As in the case of the State laws, officers of corporations are counted in determining whether the employer is subject to the tax, whereas individual proprietors and partners are not counted. The tax, however, is relatively unimportant from the standpoint of effect upon the form of organization, because the taxpayer is given credit for the amount of unemployment insurance tax paid to the States prior to the due date of the Federal return, up to 90 per cent of the Federal tax.[17] Since the State rates are generally 90 per cent of the Federal rates, credit is usually taken for the full State tax Thus, the Federal tax is, in effect, 1/10 of the rates on page 174 Because of the difference between the Federal and State laws as to the number of employees required to make an employer liable, a business may pay State unemployment insurance taxes and no Federal tax. On the other hand, a business which has its employees scattered over the country may be subject to the Federal tax and may not be liable for any State tax, unless it voluntarily becomes subject thereto. For purposes of this discussion, it is fair to say that in most instances the State unemployment insurance taxes are more important than the Federal unemployment insurance tax as a factor in selecting the form of organization.

The Federal insurance contributions (old-age benefits tax) are not so important as either the State or Federal unemployment taxes, from the standpoint of form of organization. The old-age benefits tax is levied upon employers of one or

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[16] Prior to 1939, the Federal unemployment tax was computed on the total amount of wages payable to employees For the calendar year 1939, the tax is based on the total wages paid, and beginning with 1940, the tax is based on the first $3,000 of wages paid to each employee Because of the tie-up between the Federal and State laws, through the credit provision described in the text, it appears likely that the States will amend their laws to make the basis the first $3,000 of wages paid

[17] By the 1939 amendments, if State contributions are paid after the due date of the Federal return (Jan 31), but on or before June 30, the credit is limited to 81 per cent (90 per cent of the credit allowable for payment made on or before the due date).

more individuals and is paid by the employer and the employee. Single proprietors and partners are not considered as employees, officers of corporations are. However, since the tax applies only to the first $3,000 of remuneration, the advantage to the unincorporated business is not very large. Furthermore, in return for his contribution, the employee will receive certain old-age benefits

The following table shows the rates of Federal and State unemployment and the Federal old-age benefits taxes

	Unemployment Insurance Tax Rates		Federal Old Age Benefits Tax*	
	Federal†	*State*‡	*Employer's*	*Employee's*
1937	2%	1.8%	1%	1%
1938	3	2.7	1	1
1939	3	2.7	1	1
1940	3	2.7	1	1
1941	3	2.7	1	1
1942	3	2.7	1	1
1943	3	2.7	2	2
1944	3	2.7	2	2
1945	3	2.7	2	2
1946	3	2.7	2½	2½
1947	3	2.7	2½	2½
1948	3	2.7	2½	2½
(For all subsequent years)	3	2.7	3	3

* Based on first $3,000 of wages paid

† Basis for 1937 and 1938 is total wages payable, for 1939, total wages paid, for 1940 and following years, first $3,000 of wages paid

‡ The rates given are applicable in most of the States, and are based on total wages payable (see footnote 10) In a few States there are also employee contributions, the term applied to the State taxes The State rates noted are subject to reduction for merit rating in most of the States after 1941. For a full explanation of the State and Federal unemployment insurance laws and of merit rating, see Prentice-Hall Unemployment Insurance Service.

Selection of organization in light of Federal income tax provisions.—Under the provisions of the Federal income tax law, businesses are really grouped under three headings: individuals, corporations, and fiduciaries. Partnerships and limited partnerships must report their net income in order that the authorities may check up the amount of income reported by the several partners to whom the income is taxed. In a partnership all income, whether withdrawn by the partners or left in the business, is considered to be the income of the partners, proportioned among them according to their agreement, and is therefore taxed under the rates applicable to individual incomes. Limited partnership associations are generally regarded as corporations and taxed as such. Syndi-

cates may be classed as partnerships or corporations, and joint stock companies as corporations.

A Massachusetts trust which is organized to conduct a business and earn income in the same manner as other enterprises is regarded as a corporation. A strict trust, such as one created for the purpose of protecting and conserving property for the benefit of beneficiaries to whom the trust income is presently or eventually to be paid, is looked upon as a trust relationship and taxed as a fiduciary. In general, the fiduciary pays the tax on the income of the trust which is accumulated, whereas the beneficiaries pay the tax on income which is distributed or distributable.

Rates of tax.[18]—An individual calculates his gross income and includes not only his business income, but other income such as rents, royalties, dividends,[19] and interest. From this he subtracts certain so-called deductions such as expenses, losses, and depreciation, leaving an amount of taxable net income. On the taxable net income, less the exemptions and credits below, he pays, under the Internal Revenue Code, two taxes: a normal tax and a surtax. Before calculating the normal tax and the surtax, the individual subtracts certain amounts called exemptions, which are $1,000 for an unmarried person and $2,500 for a married person or the head of a family. An additional exemption of $400 is allowed for each dependent under eighteen years of age and for each dependent above that age physically or mentally disabled. Furthermore, a credit equal to 10 per cent of the earned net income is deductible from net income before computing the normal tax.[20] After these deductions have been made, the normal tax is

[18] The individual rates of tax described here are applicable to all resident individuals, whether citizens or not, and the corporation rates are applicable to all domestic corporations

[19] Until 1936, individual stockholders were not subjected to the normal tax on dividends received, but only to the surtax, on the theory that since the corporation had already paid a normal tax on its net earnings, a second normal tax should not be imposed on the same earnings when distributed as dividends.

[20] In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income-producing factors, a reasonable allowance as compensation for the personal services actually rendered by the taxpayer, not in excess of 20 per cent of his share of the net profits of such trade or business, is considered as earned income The credit for earned income is limited by two provisions: (1) that earned income in excess of $14,000 is not recognized as earned and (2) that the earned net income shall not exceed 10 per cent of the taxpayer's net income On the other hand, amounts of net income up to $3,000 are recognized as earned, whether earned or not.

TABLE NO 2
RATES AND AMOUNTS OF TAX ON INDIVIDUALS UNDER THE INTERNAL REVENUE CODE

	Single Person Personal Exemption, $1,000					Married Person Personal Exemption $2,500				
1	2	3	4	5	6	7	8	9	10	11
Net Income	Normal Tax Rate %	Surtax Rate %	Normal Tax Plus Surtax Rate %	Total Tax	Ratio of Total Tax to Net Income	Normal Tax Rate %	Surtax Rate %	Normal Tax Plus Surtax Rate %	Total Tax	Ratio of Total Tax to Net Income
$1,000										
1,500	4			$14	000					
2,000	4		.	32	016					
2,500	4			50	020		.			
3,000	4			08	023	4		.	$8	003
3 500	4			86	025	4			26	007
4,000	4			104	026	4			44	011
4,500	4			122	027	4			62	014
5,000	4			140	028	4			80	016
5,500	4	4	8	178	032	4			98	018
0,000	4	4	8	216	030	4			116	010
6,500	4	4	8	254	039	4			134	021
7,000	4	4	8	292	042	4	4	8	172	025
7,500	4	5	9	335	045	4	4	8	210	028
8,000	4	5	9	378	047	4	4	8	248	031
8,500	4	5	0	421	050	4	4	8	286	034
9,000	4	5	9	464	052	4	5	0	320	037
9,500	4	6	10	512	054	4	5	9	372	039
10,000	4	6	10	560	056	4	5	9	415	042
12,000	4	7	11	762	064	4	6	10	602	050
14,000	4	8	12	984	070	4	7	11	800	058
16,000	4	9	13	1,234	077	4	8	12	1,044	065
18,000	4	11	15	1,514	084	4	9	13	1,209	072
20,000	4	13	17	1,831	092	4	11	15	1,580	079
22,000	4	15	19	2,194	100	4	13	17	1,919	090
26,000	4	17	21	3,014	116	4	17	21	2,699	104
32,000	4	19	23	4,374	137	4	19	23	4,020	126
38,000	4	21	25	5,851	154	4	21	25	5,479	144
44,000	4	24	28	7,504	171	4	24	28	7,084	161
50,000	4	27	31	9,334	187	4	27	31	8,809	177
56,000	4	31	35	11,394	203	4	31	35	10,869	194
62,000	4	35	39	13,694	221	4	35	39	13,109	211
68,000	4	39	43	16,234	239	4	39	43	15,589	229
74,000	4	43	47	19,014	257	4	43	47	18,309	247
80,000	4	47	51	22,034	275	4	47	51	21,209	266
90,000	4	51	55	27,494	305	4	51	55	26,609	296
100,000	4	55	59	33,354	333	4	55	59	32,469	325
150,000	4	58	62	64,324	429	4	58	62	63,894	423
200,000	4	60	64	96,304	481	4	60	64	95,344	477
250,000	4	62	66	129,284	517	4	62	66	128,294	513
300,000	4	64	68	163,264	544	4	64	68	162,244	541
400,000	4	66	70	233,244	583	4	66	70	232,194	580
500,000	4	68	72	305,224	610	4	68	72	304,144	608
750,000	4	70	74	490,204	654	4	70	74	489,094	652
1,000,000	4	72	76	680,184	680	4	72	76	679,044	679
2,000,000	4	73	77	1,450,174	725	4	73	77	1,449,019	724
5,000,000	4	74	78	3,790,164	758	4	74	78	3,788,904	758
Over 5,000,000	4	75	79	.	.	4	75	79	.	.

The above computations are based on the maximum earned income of $14,000, incomes of less than that amount are treated as all earned

4 per cent of the amount of the net income in excess of exemptions and credits.

The surtax begins at $4,000 of surtax net income, and the rate on the first $2,000—that is, on amounts between $4,000 and $6,000—is 4 per cent. The surtax on the taxable net income from $6,000 to $8,000 is 5 per cent, thereafter, it increases gradually for each additional amount of surtax net income, as is shown in the table on page 176

The table on page 176 shows the amount of Federal income tax for any amount of income. Suppose, for example, it is desired to find the tax on $32,571 43 for a married man with no dependents. The nearest amount given below the stated amount is $32,000, the tax on which (column 10) is $4,029. On the excess amount of $571.43, the normal tax would be calculated at the rate of 4 per cent (column 7) and the surtax would be calculated at the rate of 19 per cent (column 8, on line opposite $32,000). The total of 23 per cent on $571.43 is $131.43, making the total tax $4,160.43.

Income taxes on corporations.—The following is a brief summary of the income tax rates applicable to corporations under the Internal Revenue Code as amended by the Revenue Act of 1939. The tax is imposed on "normal-tax net income," which means net income minus the credit for interest on obligations of the United States and its instrumentalities, and minus the credit for dividends received.

The rates indicated are effective for all taxable years after December 31, 1939.[21]

1 Corporations with normal-tax net incomes of not more than $25,000 are taxed at the following rates. upon the first

[21] The methods of taxing corporations under the 1938 Act and the rates of tax are not explained here, even though the rates under that Act will apply to returns for the calendar year 1939 and to returns for fiscal years beginning in 1939 and ending in 1940 For purposes of comparison, however, it is interesting to note that under the 1938 Act, corporations with net incomes substantially more than $25,000 are taxable at the rate of 19 per cent, but this amount may be reduced to 16½ per cent if the "dividends paid credit" is sufficiently large In most cases the dividends paid credit is the amount of dividends paid to stockholders Under the 1936 Act corporations paid a normal tax ranging from 8 per cent to 15 per cent, plus a tax on undistributed profits ranging from 7 per cent to 27 per cent (See footnote 24 on page 572) Under previous Acts there was no surtax upon undistributed profits The rate under the 1934 and 1932 Acts was 13¾ per cent In the years 1931 and 1930, the income tax on corporations was 12 per cent, in 1929, the rate was 11 per cent, in 1928, 12 per cent; in 1927 and 1926, 13½ per cent; in 1925, 13 per cent, and from 1922 to 1925, 12½ per cent

\$5,000, 12½ per cent; upon the amount in excess of \$5,000 and not in excess of \$20,000, 14 per cent; upon the amount in excess of \$20,000, 16 per cent.

2. Corporations with normal-tax net incomes of more than \$25,000 pay a tax at the rate of 18 per cent

3. Corporations with normal-tax net incomes slightly in excess of \$25,000 may pay an alternative tax, if the alternative tax is less than 18 per cent of the normal-tax net income. The alternative tax is the sum of \$3,525 plus 32 per cent of the amount over \$25,000. If the normal-tax net income is between \$25,000 and \$31,964, the alternative tax is always less. If the net income is in excess of \$31,964, the 18 per cent rate is always less. The alternative method is designed to provide a proper transition between the two classes of corporations described in "1" and "2."

Other Federal annual taxes on corporations.—Any comparison of taxes for incorporated and unincorporated business must take into account the capital stock tax and the excess profits tax, both of which are found in the Internal Revenue Code, to determine the complete burden of Federal taxes.

The capital stock tax may ordinarily be calculated as \$1 for every \$1,000 of the adjusted declared value of the capital stock.[22] The excess profits tax is in addition to the income tax on corporations and applies to the net income in excess of 10 per cent of the adjusted declared value of the capital stock. The rates of tax are as follows:

6 per cent of such portion of the net income as is in excess of 10 per cent and not in excess of 15 per cent of the adjusted declared value.

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[22] For the year ended June 30, 1938, the tax was based on the capital stock as declared by the corporation The corporation could declare whatever value it saw fit A reasonable value was assured by means of the excess profits tax, which is based upon the relation of the net income of the corporation to such declared value For the taxable years ending June 30, 1939 and June 30, 1940, the declared value will be the value declared in the return for the year ended June 30, 1938, adjusted as provided for in the law, unless the corporation elects to increase such valuation, as permitted by the 1939 Revenue Act The adjustments referred to ordinarily consist of adding the consideration received during the year for stock issues and the net income and subtracting dividends paid. Under the 1939 Act, domestic corporations may arbitrarily increase, but not decrease, their capital stock valuation for the years ending June 30, 1939 and June 30, 1940. For the year ending June 30, 1941, and each third year thereafter, a new declaration of value, permitting increases or decreases in valuation, will be available.

12 per cent of such portion of the net income as is in excess of 15 per cent of the adjusted declared value.

Thus, if the declared value of the capital stock on the return for the year ended June 30, 1939 was $100,000, and the net income for the calendar year 1939 was $18,000, the excess profits tax of the corporation for the calendar year 1939 would be 6 per cent of $5,000, $300, plus 12 per cent of $3,000, $360, or a total of $660.

Comparison of incorporated and unincorporated forms of doing business.—From an income tax standpoint, when is it more advantageous to do business under the incorporated form than under the unincorporated form of organization? The answer to this question depends upon such facts as (1) the size of the income expected to be earned by the business, (2) the portion of income which will be reinvested in the business; (3) the income of the owners of the business from sources outside of the business; (4) the rates of taxation applicable to individuals and to corporations. The conclusions reached with regard to the relative tax burdens on incorporated and unincorporated businesses under a tax law that imposes low normal, surtax and corporation rates may be different from conclusions found under a later tax law which raises the normal and surtax rates substantially and lowers the corporation tax.

Under the Internal Revenue Code, as amended by the Revenue Act of 1939, which imposes a normal tax of 4 per cent, surtax rates ranging from 4 per cent to 75 per cent, and a corporation tax of 18 per cent, the following conclusions can be reached: (1) If all or part of the profits are properly retained in a business,[23] the corporate form may show less burdensome taxes than the unincorporated form, depending upon the amount of income, the salaries, and the dividends. (2) If all the profits are distributed to the stockholders, more taxes will be paid under the incorporated form than under the unincorporated form. This is obvious from the fact that if the entire net income of a corporation over and above the salaries paid to its stockholder-officers is paid to them in

[23] Where a corporation accumulates its profits in order to avoid the surtaxes on its stockholders, it may, under section 102 of the Internal Revenue Code, be assessed a surtax upon "undistributed section 102 net income" equal to the sum of the following (a) 25 per cent of the amount not in excess of $100,000 plus (b) 35 per cent of the amount in excess of $100,000. See also page 570, footnote 18.

dividends, the amount received by them would equal their shares of the profits of the same business if it were a partnership.[24] The entire amount of the corporation tax, therefore, plus the Federal capital stock and excess profits taxes is saved if the partnership form of organization is used.

In order to illustrate the above conclusions, we shall present several cases.[25]

An example.—We may assume that a business has an income of $150,000 and is owned by three people, *A*, *B*, and *C*. Let us consider the following cases:

I A partnership where all the interests are equal.

II Case I incorporated, but salaries paid amounting to $20,000 for each person and the profits all divided

III. A partnership where salaries are paid to *A*, *B*, and *C*, respectively, amounting to $30,000, $10,000, and $10,000, and the profits are divided in the same proportion.

IV. Case III incorporated, profits all divided.

V. Case III incorporated, profits above salaries all undistributed.

VI. A partnership where salaries are paid to *A*, *B*, and *C*, respectively, amounting to $50,000, $25,000, and $25,000, and the profits are divided in the same proportion.

VII. Case VI incorporated, profits all divided.

VIII. Case VI incorporated, profits above salaries all undistributed.

In all cases involving the corporation, the value of the stock is assumed to be $1,500,000, for the purpose of calculating the capital stock tax and the excess profits tax Since this is ten times the net earnings, there will be no excess profits tax. The capital stock tax in each case will be $1,500.

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[24] Since the earned income credit is slightly different for members of a partnership than for persons paid by a corporation (see footnote 20), the individual's income tax as a stockholder-officer of the corporation will be somewhat different from his income tax as a member of a partnership The difference, however, is negligible, as indicated in the cases in the example

[25] To illustrate how the corporate form may prove more burdensome than the unincorporated form when all profits are properly retained in the business would require a different set of facts than those given in the above examples, and would take us too deeply into a discussion of taxation It is obvious, however, that the total tax payable by the partners must aggregate less than 18 per cent of the net income of the corporation in order for the corporate form to prove more burdensome than the unincorporated form

CASE I (PARTNERSHIP)

	Income	*Tax payable*
A	$50,000	$8,885
B	50,000	8,885
C	50,000	8,885
Total tax on partners		$26,655

CASE II (CORPORATION)

	Salary	*Share in profits*	*Tax payable*
A	$20,000	$30,000	$8,869
B	20,000	30,000	8,869
C	20,000	30,000	8,869
Total tax on individuals			$26,607
Corporate income tax[26]			16,200
Federal capital stock tax			1,500
Total tax			$44,307

CASE III (PARTNERSHIP)

	Salary	*Share in profits*	*Total income*	*Tax payable*
A	$30,000	$60,000	$90,000	$26,669
B	10,000	20,000	30,000	3,601
C	10,000	20,000	30,000	3,601
Total tax on partners				$33,871

CASE IV (CORPORATION)

	Salary	*Share in profits*	*Tax payable*
A	$30,000	$60,000	$26,669
B	10,000	20,000	3,585
C	10,000	20,000	3,585
Total tax on individuals			$33,839
Corporate income tax			18,000
Federal capital stock tax			1,500
Total tax			$53,339

CASE V (CORPORATION)

	Salaries	*Tax payable on salaries*
A	$30,000	$3,569
B	10,000	415
C	10,000	415
Total tax on individuals		$4,399
Corporate income tax		18,000
Federal capital stock tax		1,500
Total tax		$23,899

[26] The corporation will report as income the $90,000 of profits left after paying the salaries amounting to $60,000 A reasonable allowance for salaries is deductible as a business expense It is assumed that the amounts of salaries mentioned in the various cases would be allowed as reasonable The subject of taxation as it relates to the amount of salaries that should be paid is discussed further in the chapter on "Management of Income," page 546

CASE VI (PARTNERSHIP)

	Salary	*Share of profits*	*Total income*	*Tax payable on income*
A	$50,000	$25,000	$75,000	$18,779
B	25,000	12,500	37,500	5,380
C	25,000	12,500	37,500	5,380
		Total tax on partners		$29,539

CASE VII (CORPORATION)

	Salary	*Share in profits*	*Tax payable*
A . .	$50,000	$25,000	$18,779
B . .	25,000	12,500	5,354
C	25,000	12,500	5,354
	Total tax on individuals . . .		$29,487
	Corporate income tax . .		9,000
	Federal capital stock tax .		1,500
	Total tax		$39,987

CASE VIII (CORPORATION)

	Salaries	*Tax payable on salaries*
A	$50,000	$8,869
B	25,000	2,489
C. .	25,000	2,489
Total tax on individuals		$13,847
Corporate income tax		9,000
Federal capital stock tax		1,500
Total tax .		$24,347

It will be noted from the cases on pages 181 and 182:

1. If the income is divided equally, it is better to conduct the business as a partnership.

2. If the income is divided in the ratio of 3 to 1 to 1, with moderate salaries, the partnership has the advantage, unless the owners care to leave their profits in the business.[27]

3. If the income is divided 2 to 1 to 1, with large salaries, the partnership has the advantage, unless the owners care to leave their profits in the business.

Effect of tax situation if owners have other income.—The form of organization cannot rest, as we have indicated here, on the income of the business alone. We must consider also the outside private incomes of the owners. To make the situation quite clear, suppose we take the first two cases above,

[27] See footnote 23, on page 179.

from which we learned that the taxes would be much less i the business were conducted as a partnership. We ma; assume that each of the owners has an income of $10,000 fron rents of buildings, interest on bonds that are not tax-exempt and like sources. Since the owners have this private income they can afford to take less out of their business, and if, as i likely to be the case, their business is growing, they wil wish to leave as much of the profits in the business as possible We may assume, therefore, that each will withdraw from th business only a salary of $10,000.

Conducted as a partnership, the business would yiel $50,000 to each member, giving him an income of $60,000, o which the total tax would be $12,345, making a total ta: burden of $37,035

If the business were conducted as a corporation, the nor mal tax and surtax to be paid by each member under the cir cumstances outlined would be levied on only $20,000; thi would be $1,605, or for all three, $4,815. The corporatio would pay income taxes on $120,000 amounting to $21,60 and a capital stock tax of $1,500. The total burden in th case would be only $23,100. Obviously, the corporate forn would be better.

Chapter X

PRINCIPLES OF BORROWING

Classification of creditors.—Money may be raised by taking the person who furnishes it into the enterprise in some form of ownership, such as partner or stockholder, or by making him a creditor. Creditors may be classified in various ways, the chief classifications being. (1) that dividing them into secured and unsecured creditors, and (2) that dividing them into long term and short term creditors.

Secured and unsecured creditors.—When a person becomes insolvent, the law regards his property as belonging, in effect, to his creditors. But because he is insolvent his assets will be insufficient to satisfy all their claims and it becomes important then to determine in what order their claims shall be paid.

If the debtor has given liens, such as a mortgage on specific pieces of property, the persons holding such liens ordinarily have a first claim on the proceeds of the sale of that property, and if several liens have been given on the same property, the several holders may demand full payment out of the proceeds of the sale in the order in which those liens were placed on the property. Thus, a house worth $10,000 may be mortgaged by *X*, its owner, to *A* for $5,000 and subsequently to *B* for $3,000. *A* and *B* will have, respectively, first and second mortgages of $5,000 and $3,000. *A* is entitled to get his $5,000 in full from the proceeds of the sale of the property before *B* gets anything If, after satisfying *A* and *B*, there is anything left, the residue will go to the general unsecured creditors.

Long and short term debts.—When money is loaned for the purchase of merchandise that is to be resold, or for the purchase of material that is to be worked up and resold, the term for which the loan is made is likely to be determined by the time it takes to resell the goods. Debts to carry such goods are ordinarily created (1) by borrowing money from a bank, (2) by accepting a draft drawn by the original seller of the goods, or (3) by giving the seller a promise, evidenced only

by an entry in the creditor's books of account. To be sure, other methods of payment may be used, such as the promissory note, but the three methods stated are the usual ones.

When, however, money is borrowed for the purchase of land, or for the construction of a building, or for acquiring any other capital goods, the term of the loan is likely to be long enough to give the borrower time to repay the loan out of the earnings of the capital assets. In such cases the loan is likely to be secured by a mortgage on the property of the borrower, and the mortgage will be accompanied by a written acknowledgment of the debt, called a bond.[1] If the loan is very large and is made by many persons, the debt it creates will be divided into similar parts each evidenced by a separate negotiable bond, and the whole secured by a mortgage made out to a trustee, who will hold the mortgage for the benefit of the bondholders. This is the usual practice where corporations borrow large sums.[2]

Forms of corporate bonds.—We shall assume that the reader is familiar with the forms of notes and drafts used in short term borrowing.[3] But we must pause to describe more fully a corporate bond in order that the reader may have some familiarity with it when we come to discuss it later.

Modern bonds usually begin with the words, "For value received the ———— Co. agrees to pay to the bearer, or if registered to the registered holder . ." Then follows the amount of the bond, usually $1,000, although $500 bonds and $100 bonds are becoming common, with the due date, interest rate, and interest dates. If the bond is made to bearer it will be called a coupon bond, for the interest payments will be represented by sheets of coupons attached to the bond. As the interest days approach, the appropriate coupon is "clipped" off by the bondholder and deposited in his bank, which forwards it for collection to the fiscal agent of the company.

A bond, such as the one described in the preceding paragraph, is negotiable, and if lost, title will be lost by the owner

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[1] A corporate bond may be defined as a written promise, under seal, to pay a specified sum of money, usually $1,000, at a fixed time in the future, usually more than ten years after the promise is made, and is usually one of a series of similar bonds all carrying interest at fixed rate, and all covered by a so-called deed of trust, or mortgage, in which the corporation's property is mortgaged to the trustee for the benefit of all the bondholders

[2] See Chapter XII.

[3] See F. A. Cleveland, "Funds and Their Uses"

STATE OF NEW JERSEY.

COMMONWEALTH WATER AND LIGHT COMPANY

FIRST AND REFUNDING MORTGAGE FIVE PER CENT. SINKING FUND GOLD BOND

Commonwealth Water and Light Company, a Corporation duly organized under the laws of the State of New Jersey, for value received, hereby promises to pay to The Farmers' Loan and Trust Company, as Trustee, or to the bearer, the sum of

One Thousand Dollars

($1000) in Gold at the office of The Farmers' Loan and Trust Company, in the City of New York, State of New York, United States of America, on the first day of August in the year nineteen hundred and forty five and to pay interest thereon in like money at the rate of five (5) per cent per annum on the first days of February and August in each year, from August 1st 1915, at the office of the said The Farmers' Loan and Trust Company, upon presentation and surrender of the Coupons hereto attached as they severally become due and payable.

This bond is one of an issue of twenty two hundred bonds numbered consecutively from one to twenty two hundred both numbers included, of which four hundred bonds numbered consecutively from one to four hundred both numbers included, are of the denomination of five hundred dollars each, and eighteen hundred bonds numbered consecutively from four hundred and one to twenty two hundred both numbers included are of the denomination of one thousand dollars each, and all being of like tenor and date and all equally secured by a first and refunding mortgage of even date herewith duly made, executed and delivered by Commonwealth Water and Light Company to The Farmers' Loan and Trust Company as Trustee, and duly recorded, conveying to the said Trustee all the corporate property, real and personal, of the said Commonwealth Water and Light Company, now owned and hereafter to be acquired by it, and all its rights, privileges and franchises as set forth in said mortgage, and this bond is issued and held subject to the terms and conditions of said mortgage.

Commonwealth Water and Light Company reserves the right to redeem this bond at any time before the first day of August 1925, upon payment to the holder thereof of one hundred and five per cent (105%) of the principal, together with accrued interest thereon; and after the 1st day of August 1925 by the payment of the principal and accrued interest thereon.

This bond shall not become obligatory until authenticated by the execution by said Trustee of the certificate hereto attached.

In Witness Whereof the said Commonwealth Water and Light Company has caused this bond to be sealed with its Corporate seal, and to be subscribed by its President and Secretary, and has likewise caused the coupons hereto annexed to be duly authenticated by the facsimile of the signature of its Treasurer, this Eleventh day of October, in the year of our Lord one thousand nine hundred and fifteen.

Commonwealth Water and Light Company

Attest: By

SECRETARY PRESIDENT

as soon as the bond gets into the hands of an innocent purchaser. To avoid such a loss, the bond may be registered either as to principal only, in which case the interest coupons are not detached, or as to principal and interest, in which case the coupons are removed. Where a so-called fully registered bond, such as was just described, is held by an investor, interest is sent to him at his registered address in the same way that dividends are mailed to stockholders

Registration of a bond consists in placing the name of the holder with his address and the date of registry in a book kept for that purpose by the trustee named in the bond, and also in writing the name of the holder on the back of the bond. Usually bonds are interchangeable, that is, the holder may exchange one form for another If, for example, he holds a fully registered bond and wishes to change it for a coupon bond, he takes it to the trustee, who cancels it and issues the proper bond in its place. Usually a small fee of from $1.00 to $2 00 is charged to cover in part the cost of making the exchange.

Trading on the equity.—The term of a loan may be extended indefinitely either by making the loan run for a long period in the original contract[4] or by renewing or refunding the loan when it becomes due.[5] This principle of long term borrowing is based on the general rule that if it pays to borrow in the first instance, it pays to continue to borrow. Thus, if a company is able to earn 10 per cent on capital, and if it can borrow money at 5 per cent, it can earn 5 per cent on the other people's money, and if its capital is half owned and half borrowed, the return on the total capital will give the company a yield of 15 per cent on its own capital. But, on the other hand, if the earnings fall below 5 per cent on its total capital,

[4] The Public Service Corporation of New Jersey has issued perpetual bonds The Elmira & Williamsport R R Co's Income 5's, dated May 1, 1863, are due in 999 years The holders of United Power & Transportation Co's Collateral 4's may demand their principal in 1949, but thereafter the bonds are payable at the option of the company Somewhat in the same way Reading R R bonds known as the Wilmington & Northern R R Stock Trust Gold 4% Certificates are due when redeemed, and are redeemable on thirty days' notice given by the company

[5] A debt is said to be "funded" when it is evidenced by securities that do not mature for a considerable period of time If these securities are exchanged for other securities either before or at the time of maturity, the loan or debt is said to be "refunded"

owned and borrowed, the income on its owned capital will be less than the earnings on its total capital, for the company will be compelled to pay 5 per cent interest on the money borrowed whether it has been earned or not. The principle can best be illustrated in the following table, wherein it is assumed in the upper part that the company is in business with $100,000 on which it earns in the first year 10 per cent, and in the second and third year 15 per cent and 3 per cent, respectively. In the lower part of the table is shown what would have happened to the company if it had borrowed an additional $100,000 at 5 per cent

TABLE NO 3

ILLUSTRATION OF TRADING ON THE EQUITY

	First Year	*Second Year*	*Third Year*
Where $100,000 owned capital is used:			
Earnings	$10,000	$15,000	$3,000
Per cent on $100,000	10%	15%	3%
Where $100,000 owned capital is used, and in addition $100,000 is borrowed at 5%			
Earnings	$20,000	$30,000	$6,000
Interest	5,000	5,000	5,000
Net Earnings	$15,000	$25,000	$1,000
Per cent on $100,000	15%	25%	1%

When a person or a corporation uses borrowed capital as well as owned capital in the regular conduct of a business, he or it is said to be "trading on the equity," and as we saw in the above example, the gains are magnified as well as the losses If, therefore, a company is reasonably sure to earn more than it pays out in the form of interest on borrowed money, it can profitably continue to borrow.

Limits to borrowing of fixed funds.—Several principles, however, may operate to limit the extent to which a company may profitably borrow money. The first principle is that already alluded to, namely, that losses are magnified as well as profits. If, therefore, a company has fluctuating income, it runs great risk of being unable to pay its interest during lean years and of bringing on a receivership with all its difficulties and losses. Thus, railroads or public utilities can much better

afford to borrow than can industrials, since the former have more stable earnings [6]

In the second place, borrowing may be limited by the principle that capital beyond a certain amount cannot be profitably employed because of the difficulty in maintaining economically an organization that can properly co-ordinate the business functions. This limitation, however, will probably seldom become a real danger in any fairly well managed concern.[7]

The third limitation on the funds that can be profitably employed is made by the extent and size of the market for the products of the concern. Large-scale production has many advantages tending to reduce costs of production,[8] but when production outruns demand, the price of the product will fall to a non-profit-yielding basis. As supply increases, prices

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[6] The following mathematical computation shows that the more stable the gross income the greater may be the amount of borrowing In order to follow the demonstration, which is in fact very simple, two expressions, "operating ratio" and "financial ratio or risk," must be understood Operating ratio is the ratio of operating expenses to gross income. Financial risk is the ratio of the interest charges to the sum available for the payment of interest charges—that is, the net income left after subtracting the operating expenses from the gross income

Let a = gross income in normal year.
b = decrease of gross income in the poorest year
m = operating ratio (ratio of operating expenses to gross income)
x = financial risk, that is, the largest possible risk that can be met in any (that is, the poorest) year

	Normal Year	Poorest Year
Gross income	a	$a - b$
Operating expenses .	am	$(a - b)m$
Net income ..	$a - am$	$(a - b) - (a - b)m$
Fixed charges	$x(a - am)$	

The quantity $x(a - am)$ is unknown, since one term is unknown Whatever it amounts to, it is by its very nature constant, that is, it will not vary from year to year It should not be larger than the net income in the poorest year, but it may be as large, in other words, it may be equal to the net income. Thus $x(a - am) = (a - b) - (a - b)m$ Factoring and solving for x.

$$x = \frac{(a - b)\ (1 - m)}{a\ (1 - m)} = \frac{(a - b)}{a}$$

That is, the financial risk (x) may be equal to the ratio of the gross income in the poorest year $(a - b)$ to the gross income in the normal year (a).

[7] See chapters on expansion and intercorporate relations.

[8] *Ibid*

naturally fall. If, however, the oversupply can be shipped to another locality, prices may be maintained.[9] In other localities competition may be stronger or the natural demand weaker than in the home market. Still, it may pay to enter these markets and meet the competitive prices. Indeed, by so doing it may be possible to prevent foreign competition from invading the home market. But when competitive prices in the foreign market become prohibitively low, the limit of production is reached, and with it the limit for the use of additional borrowed capital. In some businesses markets that bring in an inadequate return must be developed. Examples abound of public utility companies temporarily carrying service to sparsely settled communities at a loss.

The fourth limitation on the funds that can be profitably borrowed arises from the fact that successive sums are ordinarily borrowed at higher rates of interest because each new sum that is advanced involves the lender in greater risk. Here again we may take a hypothetical example. Suppose a concern makes a net income of $400,000 in the average year, that its gross income is $1,000,000, and that the company has three successive mortgages on which it pays interest amounting respectively to $200,000, $100,000, and $50,000. Let us see what the factors of safety are for these three mortgages in a normal year and in a year when the gross income drops only 10 per cent.

[9] An interesting example of the uses of foreign markets is quoted from the *Wall Street Journal*, December 20, 1911, by Professors Marshall, Wright, and Field, in "Materials for the Study of Elementary Economics," page 421: "Edison told Mr. Edmonds a very interesting personal anecdote, especially pertinent at this time when the accusation is made that the United States is dumping large amounts of manufactured products on the foreign market. Edison said: 'I was the first manufacturer in the United States to adopt the idea of dumping surplus goods upon the foreign market. Thirty years ago my balance sheet showed me that I was not making much money. My manufacturing plant was not running to its full capacity. I couldn't find a market for my products. Then I suggested that we undertake to run our plant on full capacity and sell the surplus products in foreign markets at less than the cost of production. Every one of my associates opposed me. I had my experts figure out how much it would add to the cost of operating the plant if we increased this production 25 per cent. The figures showed that we could increase the production 25 per cent at an increased cost of only about 2 per cent. On this basis I sent a man to Europe who sold lamps there at a price less than the cost of production in Europe. By doing this I was able to employ more labor to run my plant to full capacity, and this labor, of course, received high wages. American consumers were not injured in the slightest, and I was enabled to employ 25 per cent more men and get rid of surplus product by dumping it upon the foreign market.'"

	Normal Year	Item	Poor Year
Gross income	$1,000,000	A	$900,000
Operating expenses	600,000	B	540,000
Income from operations	$400,000	C	$360,000
Interest on first mortgage	200,000	D	200,000
	$200,000	E	$160,000
Interest on second mortgage	100,000	F	100,000
	$100,000	G	$60,000
Interest on third mortgage	50,000	H	50,000
Net income	$50,000	I	$10,000

If we call the ratio of what is left after paying the interest to the amount of the interest the "factor of safety,"[10] we can readily compute the result as follows:

		Normal Year	Poor Year
Factor of safety of first mortgage	(E D)	100%	80%
Factor of safety of second mortgage	(G F)	100%	60%
Factor of safety of third mortgage	(I H)	100%	20%

Thus it will be seen that the third mortgage, which apparently has as good a position as the first mortgage during a normal year, falls close to the danger line when there is a drop of only 10 per cent in the gross revenue. Indeed, if we had assumed that the operating expenses had not fallen in the same proportion as did the gross revenues, but had fallen only to, say, $576,000,[11] the third mortgage interest would not

[10] The ratio of *E* to *D*, and so forth, is the "factor of safety"; the amounts left after paying the interest in the several cases are properly called "margins of safety"; the ratio of all the interest payments, *D* plus *F* plus *H*, to the amount available therefor, *C*, is the financial ratio or risk It should be noted that financial statisticians who understand their business would not report the factor of safety of the second mortgage as the ratio of *G* to *F* In each case of junior mortgages the factor of safety is the ratio of what is left after paying interest on that mortgage to the interest on that mortgage plus the interest on all preceding mortgages The factor of safety, therefore, of the second mortgage is the ratio of *G* to *F* plus *D*, and of the third mortgage the ratio of *I* to *H* plus *F* plus *D* In the table in the text the factor of safety is expressed as 100 per cent in each case to show the relatively poor position of the junior mortgages in the poor year

[11] Operating expenses ordinarily do not vary directly with the gross revenues. A little more or a little less business will likely have no effect at all on the operating expenses In the assumption above, it was reckoned that only 40 per cent of the operating expenses are variable; that is, instead of the operating expenses shrinking by a full 10 per cent, they would shrink only 10 per cent of 40 per cent, or 4 per cent Thus we decreased the operating expenses by 4 per cent of $600,000, or $24,000. In Chapter XXVI is a chart, taken by

have been met in the poor year by $26,000. The factor of safety, in other words, would have been minus 52 per cent.

Advantages of consolidated borrowing.—Let us assume that the interest rates on the mortgages in the previous example were respectively 5, 6, and 7 per cent and that the amounts of the mortgages were therefore about $4,000,000, $1,666,666, and $714,284. If, now, these mortgages could be consolidated into one mortgage bearing 5¼ per cent interest, the situation in the two years would work out thus:

	Normal Year	*Poor Year*
Gross Revenue	$1,000,000	$900,000
Operating Expenses	600,000	540,000
Net Income	$400,000	$360,000
Interest	335,000	335,000
Surplus	$65,000	$25,000
Factor of Safety	19 37%	7 46%

The factor of safety dropped 12 points, from about 19% to about 7%, whereas in the case of the third mortgage in the previous example it dropped a full 80 points, and in the case of even the first mortgage it dropped 20 points. Moreover, it will be noticed that the total amount of interest paid in the second example was $335,000, as against $350,000 in the first, where there were three separate mortgages.[12] The saving accomplished by consolidating the mortgages amounts annually to $15,000.[13]

permission from Mr Samuel I Wyer, "Regulation, Valuation and Depreciation of Public Utilities," in which are shown graphically the variable and fixed operating costs of certain utilities In the case of the steam railroad, for example, about 50 per cent of the operating costs have to be met whether business is good or bad; the other 50 per cent varies more or less directly with the variations in gross income

[12] The above example is not typical of the large corporation It is only in the smaller corporations that the junior mortgages decrease in amount. In large, growing corporations it is customary for the first mortgage to be a small underlying mortgage placed on the property when the corporation was small and struggling Subsequent mortgages are made after the corporation has gotten well on its way In such corporations, therefore, the mortgages that bear the high rates of interest are for the larger amounts, and consolidation of these large mortgages with a reduced rate of interest will show a great saving in fixed charges.

[13] A saving that should also be noted, and that represents an important item, is the cost—in legal fees, advertising costs, and the like—of financing under separate mortgages and of refinancing as the mortgages fall due. For other advantages, see pages 228 *et seq*

Some general principles of borrowing.—From the foregoing discussion in this chapter we may deduce several principles of finance which it will be well to set down here by way of summary.

1. The last dollar is the most expensive dollar. This is true because the last dollar takes the greatest risk and demands a higher return to compensate for the risk Another reason, quite apart from the legal reason that liens are paid off in the order in which they are placed on property, is that the last dollar occupies the strategic position of rescuing the other dollars. Thus a concern may be in fair condition but may need some money to tide over bad times. The people who provide this money realize the great benefit it brings to the concern and demand commensurate compensation. Moreover, it frequently happens that the "last dollar" will be raised in times when money is scarce, and for this reason the interest rate will be high.

2. From the foregoing, and also from the discussion previous thereto, it follows that a single large bond issue is better than a number of small issues.

3. We may reiterate the principle already enunciated, that corporations with stable earnings may borrow more than corporations with fluctuating earnings.[14]

4. Since the last dollar is the most costly dollar, whatever can be done to reduce the cost of this dollar should be done. If a company has been financed without regard to financial principles, when the last dollar is sought it is likely to prove to be the straw that breaks the camel's back. But a wisely financed company can borrow extra money even in times of stress, for it will have saved its best security till the last. During periods of prosperity it will finance expansions through the sale of stock or debenture bonds.[15] When it runs upon bad times it will probably have little difficulty in issuing securities that have a first claim on earnings. For this reason some companies, as soon as the opportunity arises, refund their bond issues into stock.[16] A movement toward refunding

[14] As to what makes for stable earnings, see chapter on management of income

[15] If the company is earning very large profits, these may be conserved for the old stockholders by issuing non-participating preferred stock for expansion purposes

[16] For example, the Anaconda Copper Mining Co in 1929 issued new stock amounting to $258,987,600. From the proceeds the company retired about

into stock was evident during the years 1927–1929 when stocks were in demand.

Relation of amount of borrowing to rate of interest.—Companies cannot afford to borrow much when they have to pay high rates of interest for the borrowed funds. In fact, when money is scarce and interest rates are high, borrowers ordinarily reduce their borrowings to a minimum and arrange the contract of loan for a short period only.[17]

Interest rates are fixed not only by demand for and supply of funds, but by the risk which the lender takes in committing

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$103,000,000 outstanding of first consolidated 6's, and a small balance of debenture 7's remaining unconverted It also retired part of its subsidiary funded debt

[17] Ordinarily the interest on a corporate bond is a fixed charge, by which is meant a charge on the earnings and assets which must be met if the company is not to be deprived of its property by its creditors (Dividends on preferred stock are often referred to as "contingent charges" and dividends on common stock as "optional charges"). Sometimes, however, companies issue bonds the interest on which is to be paid only when the company earns it Such bonds are called income bonds They are somewhat rare and suffer from the fact that they are usually given in cases where the earnings will hardly meet the interest requirements Nice questions of accounting may arise in calculating income available for these bonds, and since the margin of income above interest requirements is small, the importance of deciding those questions one way or the other will likely lead to vexatious litigation (See Central of Georgia R Co v Cent Trust Co. of N Y, 135 Ga 472; Spies v Chic & East. Ill R. Co, 40 Fed 34; Thomas v N Y. & G. L Ry. Co, 139 N Y 163; Un. Pac. R. Co. v. U S., 99 U S 402, 420, Barry v. Mo., K. & T R Co., 27 Fed 1; Day v. Ogdensburgh & L C. R. Co, 107 N Y 129; Lehigh Coal & Nav Co v. Cent. R. Co. of N J, 34 N. J Eq 88; Whitridge v. Mt Vernon Woodberry Cotton Duck Co, 210 Fed. 302; Morse v Bay State Gas Co., 96 Fed. 938, 940, 946; Hubbard v. Galveston, etc, R Co, 200 Fed 504, Edwards v International Pavement Co, 227 Mass 206.) Income bonds are usually secured by second or third mortgages, and the arrearages of unpaid interest are sometimes accumulated and sometimes not Where arrearages of interest on income bonds must be met before dividends can be paid on stock, the bonds are called cumulative. See, for an example, C W Gerstenberg, "Materials of Corporation Finance," page 936.

In very rare cases corporations have issued "participating" or "profit-sharing" bonds Whereas the holders of income bonds may receive less interest than a stipulated maximum, holders of participating or profit-sharing bonds may receive more than a stipulated minimum, depending on the earnings of the company and the terms of the contract. During 1927 and 1928 several toll bridge companies issued participating debenture bonds The first sinking fund gold debenture 6½'s of the San Francisco Bay Toll Bridge Co have attached thereto coupons entitling holders to participation on interest dates in semiannual net earnings, after certain specific deductions, to the extent of 1½ per cent of the principal amount of debentures outstanding. A similar arrangement is found in the Detroit International Bridge Co participating 7 per cent debentures of 1952 Both companies defaulted in interest payments on the bonds during the depression

his funds to a particular borrower.[18] For this reason, old, well-established concerns can borrow more freely than young concerns whose reputations have not been established. Moreover, the nature of the business will have some effect; railroads, for example, ordinarily pay a much lower rate than industrials, because the earnings of the former are more stable

A small difference in interest rate does not seem important, but if the difference between rates, such as 5 and 5½, is accumulated over the life of the loan, it will be found to amount to a large sum. For example, if the difference between a 5 per cent rate and a 5½ per cent rate on an issue of $1,000,000 running for 100 years is accumulated at compound interest at 5 per cent, at the maturity of the issue the amount saved will equal $1,315,012.58—more than the face amount of the bonds. To put it another way, a company that can borrow at 5 per cent can borrow, at the same aggregate annual cost, about 10 per cent more than a company that must pay 5½ per cent.

Selling loans at a discount.—When a company borrows money, it may be said to sell its credit. It in effect gives its credit for the amount of cash it receives. What it really does is to agree to make a certain number of interest payments at various times in the future and finally to pay a certain sum of money, called the principal. The lender has the right to receive in the future various sums of money. These rights are not worth at the present time their face value. That is, a hundred-year bond for $1,000, interest 5 per cent, is not now worth $1,000 plus 100 times $50 (100 annual interest payments of $50 each). Each payment must be reduced to its present worth. To find the present worth, for example, of the principal of $1,000 due in 100 years, we must discover what sum placed at 5 per cent compound interest for 100 years will amount to $1,000.[19] In the same way we can find the

[18] When the price of bonds is fixed, the buying tendencies of investors must be considered, just as purchasing habits must be considered in selling any line of goods For example, during the strong investment market prior to the break of 1929, investment bankers fixed the interest on bonds at a rate which would permit pricing of the security at less than par The reason for this was that investors were found to be willing to pay better prices for a bond bearing a low coupon rate and sold at a discount than to pay par or a premium on a bond carrying a high rate of interest The calling of many bonds long before maturity had made the investor look upon the purchase of a bond at a discount as an opportunity for a speculative profit.

[19] The answer is $7 60449 if the compounding is done annually.

present worth of all the interest payments.[20] The more remote interest payments will be worth at present very little, the one that is first due will be worth very nearly its face value. The sum of the present worths of the principal and all the coupons will be just $1,000, or exactly what the bond costs.

With this brief explanation we may show the effect of selling bonds at a discount, as far as the burden to the company is concerned.

A perpetual loan for 4 per cent sold at 80 will be equivalent to a perpetual loan for 5 per cent sold at par. The company which sells a 4 per cent bond at 80 will give annually $40 for the use of $800, or just 5 per cent. Where the bond has a maturity date, the difference between what the company gets and what it eventually must pay back is the discount, and this, by a process known as amortization, may be added to the interest charge annually. Thus, in a crude way, if the two bonds referred to in the above example ran for ten years, the bond which sold at a discount would cost the company not only 5 per cent for its money, but the discount of $200, or $20 a year for ten years, bringing interest on $800 from $40 to $60, or from 5 per cent to 7½ per cent.[21]

Probably a company makes the best bargain when it adjusts the interest rate to make the bonds sell at par or slightly below par. In practice, for several reasons that need not be mentioned here, bonds whose interest rates are so fixed that they will sell at a discount are more easily disposed of than those which sell at a premium.

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[20] For a brief explanation see "Jordan on Investments," Chapter XXV

[21] In practice the rate would not be considered 7½ per cent, but would be found by consulting a table of bond yields Johnson's table, for example, shows that a 4 per cent bond selling at 80 to mature in ten years has an effective yield of 6 787 per cent

Chapter XI

SECURED BORROWING

Kinds of security.—In the previous chapter we discussed some general principles of borrowing We must now turn our attention to the methods employed by corporations in carrying these principles into effect

When a business man has "good credit," by which is meant that he has sufficient evident earning power to pay his debts, current and prospective, he is said to be trusted. Creditors will readily turn over property to him, relying on his general ability and proven willingness to pay at the proper time. But when there is any doubt about his ability to pay, or when his contract calls for payment at some distant day and contingencies are likely to arise that may impair his ability to pay on the appointed day, creditors may demand specific security. Thus we have the ordinary real estate mortgage. In business transactions the security may take the form of a special mortgage on specific property, or the form of a general mortgage on all property owned or later acquired by the debtor. Corporate mortgages securing large bond issues are usually of the general variety. A third form of security that has become popular is the so-called equipment mortgage, in which the relations of all the parties involved are somewhat complex, the complexity being due to a desire on the part of the creditor to get a specific lien on the property prior in claim to encumbrances that would rest on the property if title were turned over to the debtor directly. Thus, as we shall see, in equipment mortgages the ownership of the property remains in the name of someone other than the debtor till the debt has been paid, though in the meantime the debtor is given the right to use the property.[1] A fourth kind of mortgage used in financing is the so-called collateral trust mortgage, in which the security consists wholly of negotiable securities—usually the stocks and bonds of subsidiaries owned by the parent company.

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[1] For a more complete account, see pages 240 *et seq*

Essentials of a mortgage.—A mortgage may be defined as a deed absolute in form, but subject to defeasance, given to secure the performance of some act upon the part of the mortgagor, usually his repayment of a loan made by the mortgagee at the time of the execution and delivery of the mortgage. Thus, in the usual transaction, the mortgagor borrows money from the mortgagee and gives as security a deed of property, which deed provides that it shall be null and void if at the time appointed the mortgagor repays the loan.[2] We can get a better idea of a mortgage by examining one in detail

Comments	*Mortgage*
Parties Notice that Brooks is stated to be unmarried, since if he were married his wife's name would have to appear as co-maker in order to make the mortgage precede her dower right	THIS INDENTURE, made this 10th day of May, 1932, between Abner Brooks (unmarried), party of the first part, and hereinafter designated the mortgagor, and Charles Dawson, party of the second part, hereinafter designated the mortgagee
Preamble or recitals.	WHEREAS, the said mortgagor is, by virtue of a bond bearing even date herewith, justly indebted to the said mortgagee in the sum of $25,000 lawful money of the United States, secured to be paid on the 10th day of May, 1934, together with interest thereon, to be computed from the 10th day of May, 1932, at the rate of 6 per cent per annum, and to be paid on the 10th day of November next ensuing the date hereof and semiannually thereafter
Granting Clause, including consideration Notice the true consideration is contained in the recitals The consideration here mentioned amounts to legal "camouflage"	NOW THIS INDENTURE WITNESSETH, that the mortgagor, for the better securing the payment of the said sum of money mentioned in the said bond or obligation, with interest thereon, and also for and in consideration of the sum of ONE DOLLAR, to the mortgagor in hand paid by the mortgagee, the receipt whereof is hereby acknowledged, does hereby grant and release unto the mortgagee, and to his heirs and assigns forever, ALL that certain lot, piece, or parcel of land, with all the buildings and improvements thereon made or erected, situate, lying and being in the Borough of

[2] In some jurisdictions, as for example, New York, the real estate mortgage has ceased being a conveyance of property subject to defeasance; it is but a lien, that is, a claim against the property, the claim amounting to a right in the lienee, that is, the mortgagee, to have his lienor's interest in the property sold to make good the debt.

Comments	*Mortgage*
	Manhattan, City, County, and State of New York, bounded and described as follows, to wit
Description of the property mortgaged	BEGINNING at a certain point on the north side of Joffre Avenue, distance one hundred feet east of that point known as the northeast corner formed by the intersection of Foch Street and Joffre Avenue, running thence (1) fifty feet due east on a line with the said Joffre Avenue; thence (2) one hundred feet due north on a line parallel with said Foch Street, thence (3) fifty feet due west on a line parallel with said Joffre Avenue; thence (4) one hundred feet due south on a line parallel with said Foch Street to the place of beginning.
	TOGETHER with all fixtures and articles attached to or used in connection with said premises, all of which are declared to be covered by this mortgage; together with the appurtenances, and all the estate and rights of the party of the first part in and to said premises
Habendum clause states the quantity of the estate conveyed Notice that if the instrument closed here, the mortgagee would get the fee, that is, the absolute title	TO HAVE AND TO HOLD the above-granted premises unto the said mortgagee, his heirs and assigns forever.
Defeasance clause states conditions under which conveyance granted in former paragraphs will be defeated.	PROVIDED ALWAYS that if the said mortgagor, or the heirs, executors, administrators, or the personal representatives, successors, or assigns of the said mortgagor, pay the said sum of money mentioned in the said bond or obligation, and the interest thereon, at the time and in the manner mentioned in the said bond or obligation, then these presents and the estate hereby granted, shall cease, determine, and be void.
Covenants The following covenants are not necessary to a complete mortgage Some are almost always included, others are usually included They are agreements by the mortgagor, who retains actual possession of the property, better to protect the mortgagee	AND the said mortgagor covenants with the mortgagee as follows:

Comments	*Mortgage*
Covenant conferring right to sell This covenant is, under the laws of most States, unnecessary	FIRST—That the mortgagor will pay the indebtedness as hereinbefore provided, and, if default be made in the payment of any part thereof, the mortgagee shall have power to sell the premises herein described according to law Said premises may be sold in one parcel, any provision of the law to the contrary notwithstanding
Covenant to insure and repair.	SECOND—That the mortgagor will keep the buildings on the said premises insured against loss by fire for the benefit of the mortgagee. And should the mortgagee, by reason of any such insurance against loss by fire, as aforesaid, receive any sum or sums of money for any damage by fire to the said building or buildings, such amount may be retained and applied by said mortgagee toward payment of the amount hereby secured, or the same may be paid over either wholly or in part to the said mortgagor, or the heirs, successors, or assigns of the mortgagor, to enable said mortgagor to repair said buildings or to erect new buildings in their place, or for any other purpose or object satisfactory to the said mortgagee, without affecting the lien of this mortgage for the full amount secured hereby before such damage by fire, or such payment ever took place
Interest and tax clause. This covenant serves to "accelerate the maturity" if taxes or interest are not paid	THIRD—And it is hereby expressly agreed that the whole of said principal sum, or so much thereof as may remain unpaid, shall become due at the option of the mortgagee after default in the payment of any tax, assessment, or water rate for sixty days after notice and demand, or in case of the actual or threatened demolition or removal of any building erected upon the said premises, anything herein contained to the contrary notwithstanding
Covenants of "general warranty" and "further assurance"	FOURTH—That the mortgagor will execute any further necessary assurance of the title to said premises and will forever warrant said title.
Right of entry.	FIFTH—That if default shall be made in the payment of the principal sum mentioned in the said bond, or of any installment thereof, or of the interest which shall

Comments | *Mortgage*

accrue thereon, or of any part of either, at the respective times therein specified for the payment thereof, the mortgagee shall have the right forthwith, after any such default, to enter upon and take possession of the said mortgaged premises, and to let the said premises, and receive the rents, issues, and profits thereof, and to apply the same after payment of all necessary charges and expenses, on account of the amount hereby secured, and said rents and profits are in the event of any such default hereby assigned to the mortgagee

Receiver.

SIXTH—And the mortgagee shall also be at liberty immediately after any such default, upon proceedings being commenced for the foreclosure of this mortgage, to apply for the appointment of a receiver of the rents and profits of the said premises without notice, and the mortgagee shall be entitled to the appointment of such a receiver as a matter of right, without consideration of the value of the mortgaged premises as security for the amount due the mortgagee, or the solvency of any person or persons liable for the payment of such amounts

The right conferred by this covenant is termed "the right of subrogation"

SEVENTH—And the mortgagor does further covenant and agree that, in default of the payment of any taxes, charges, and assessments which may be imposed by law upon the said mortgaged premises, or any part thereof, it shall and may be lawful for the said mortgagee, without notice to or demand from the mortgagor, to pay the amount of any such tax, charge, or assessment, and any amount so paid the mortgagor covenants and agrees to repay to the mortgagee, with interest thereon, without notice or demand, and the same shall be a lien on the said premises, and be secured by the said bond and by these presents and the whole amount thereby secured, if not then due, shall thereupon, if the mortgagee so elect, become due and payable forthwith, anything herein to the contrary notwithstanding

So-called Brundage clause. Inserted in mortgage principally to permit mortgagee to

EIGHTH—It is hereby further agreed by the parties hereto that if, at any time before said bond is paid, any law be enacted chang-

Comments	*Mortgage*
raise the rate of interest equal in amount to any taxes that State may impose on the mortgagee in respect to the mortgage	ing the law in relation to taxation so as to affect this mortgage or the debt thereby secured, or the owner or holder thereof, in respect thereto, then said bond and this mortgage shall become due and payable at the expiration of thirty days after written notice requiring the payment of the mortgage debt shall have been given to the owner of the mortgaged premises, anything herein contained to the contrary notwithstanding
Covenant to give estoppel certificate, which, if the mortgagee wishes to sell the mortgage, will be demanded by the purchaser of the mortgage	NINTH—The mortgagor, or any subsequent owner of the premises described herein, shall, upon request, made either personally or by registered mail, certify, in writing, to the mortgagee or any proposed assignee of this mortgage, the amount of principal and interest that may be due on this mortgage, and whether or not there are any offsets or defenses to the same, and upon the failure to furnish such certificate after the expiration of six days in case the request is made personally, or after the expiration of thirty days after the mailing of such request in case the request is made by mail, this mortgage shall become due at the option of the holder thereof, anything herein contained to the contrary notwithstanding.
Acceleration of maturity on account of violation of municipal ordinances.	TENTH—It is expressly understood and agreed that the whole of said principal sum and the interest shall become due at the option of the mortgagee, upon failure of any owner of the above described premises to comply with any requirement of any department of the City of New York, within six months after notice in writing of such requirements shall have been given to the then owner of said premises by the mortgagee, anything herein contained to the contrary notwithstanding
Covenant as to communications	ELEVENTH—Every provision for notice and demand or request contained herein shall be deemed fulfilled by written notice and demand or request personally served on one or more of the persons who shall at the time hold the record title to the premises, or on their heirs or successors, or by registered mail directed to such person or persons or their heirs or successors, at his, their, or its address to the mortgagee last known.

IN WITNESS WHEREOF, the said mortgagor hath signed and sealed this instrument the day and year first above written

ABNER BROOKS (Seal)

Signed, sealed, and delivered
in the presence of
Edward Frothingham
George Hamilton

State of New York }
County of New York } ss

On this 10th day of May, 1932, before me personally came Abner Brooks, to me known and known to me to be the person described in and who executed the foregoing instrument, and he duly acknowledged to me that he executed the said instrument for the purposes therein contained

ISAAC JOHNSON,
Notary Public No 1001,
County of New York,
State of New York

(Notarial Seal)

Operation and purpose of mortgage.—Under the common law the real estate mortgage printed above operated just as it read, as a transfer of the legal title of the property. The mortgagee then had the legal title, which the mortgagor could get back upon the payment of the loan. This right to get back the legal title is called the equity of redemption.

If now the day comes around for the repayment of the loan, and the money is not forthcoming, the mortgagee may begin foreclosure proceedings. The common law proceedings are now sometimes called "strict foreclosure" to indicate that their purpose is to foreclose the mortgagor from claiming in the future the right to redeem. These foreclosure proceedings in effect vested the equitable as well as the legal title in the mortgagee. Under modern statutes foreclosure proceedings usually take the form of what is known as "foreclosure and sale." An action is brought, the purpose of which is to get a decree from an equity court directing the sale of the property for the benefit of the mortgagee. If a first mortgage is being thus foreclosed, the property sold is really the interest of the mortgagor, as well as the interest of the second mortgagee, if there be one, and of all persons getting interests in the property subsequent to the recording of the first mortgage. Thus, if a second mortgage is being foreclosed, the owner, the third mortgagee, and subsequent mortgagees are made parties to the action since it is their interests which are being sold. The purchaser at the foreclosure sale would take the property

subject to the first mortgage and subject to taxes, but clear of the other liens

Under very modern statutes, as, for example, in New York, mortgages are worded not as a conveyance but as a lien, and the only kind of action to be brought is a foreclosure of the lien. The general effect is the same as foreclosure and sale.

An illustration.—The principles contained in the foregoing paragraphs are so important that it seems advisable to clarify them by means of an illustration. Thus, we may assume that *A*, the owner of property reasonably worth $100,000, mortgages it to *B* for $60,000, and then to *C* for $20,000, and then to *D* for $15,000. *B* will be said to have a first mortgage, *C* a second mortgage, and *D* a third mortgage. What really has happened is this: *A* has turned over his legal title to *B*, and has retained an equitable right, called the equity of redemption, that is, the right to get back what he has transferred upon giving back to *B* the amount *B* has loaned. When *A* gives the second mortgage to *C*, he really turns over to him the equity behind *B*'s mortgage and takes back another equity of redemption. This second equity of redemption is the right to redeem the first equity of redemption. And the same process takes place with the third mortgage.[3]

We can now bring out the relationship in still more detail by assuming that a mortgage is foreclosed. If the interest on the third mortgage is not paid, it will be foreclosed and the purchaser at the foreclosure sale will buy the equity which the owner had, plus the third mortgagee's interest in the property. Nominally this was worth $20,000. Let us suppose the sale brought $12,000 and was made to *X*. What would *X* get? He would get the property encumbered with the mortgages to *B* and *C*. Since *D*'s mortgage was for $15,000, *D* would not be paid in full out of the sale and would look to *A* personally for the deficiency. If *A* had sold the property to *W* before the foreclosure, and *W* had assumed all the mortgages, *D* would collect the deficiency judgment from *W*.[4]

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[3] The word "equity" is often used in two senses first, as an abbreviation of "equity of redemption," in which case it may be defined as a legal right; and, second, as the value of that right. In the above example *A* had an equity of $40,000 after giving the first mortgage, an equity of $20,000 after giving the second mortgage, and an equity of only $5,000 after giving the third mortgage.

[4] *W* would not be personally liable for deficiency judgments if he took the property "subject to" the mortgages and not "assuming" them

Now, let us suppose the facts as they were originally, but that the interest on *B*'s mortgage is not paid. Let us suppose that *B* forecloses. He would bring his action against *A*, the owner, and against *C* and *D*, the subsequent mortgagees. The property now would be sold to a purchaser who would get it free from all encumbrances. If *X* bought it and paid only $50,000 for it, *B* would get the entire $50,000. (We omit for the sake of simplicity the cost of the foreclosure proceedings, though in fact they are first to be paid from the proceeds of the sale.) *B* would also have a deficiency judgment against *A* for $10,000, since *A*'s personal debt on his bond is in fact $60,000, of which only $50,000 was paid by the foreclosure sale.

C and *D* also could hold *A* personally for the amounts of the mortgages they hold.[5]

If *X*, instead of paying $50,000, had paid $70,000, this latter sum would be divided $60,000 to *B* and $10,000 to *C*. If *X* paid $85,000, this sum would be divided $60,000 to *B*, $20,000 to *C*, and $5,000 to *D*. If, by any chance, the property sold for $97,000, the sums paid would be $60,000 to *B*, $20,000 to *C*, $15,000 to *D*, and $2,000 to *A*.

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[5] See first paragraph, page 206.

Chapter XII

CORPORATE MORTGAGES

Corporate mortgages.—When a piece of real estate is mortgaged, the mortgagor gives the mortgagee two instruments, one the mortgage, and the other the bond or note.[1] The latter instrument evidences the personal obligation of the debtor to repay the loan, and the mortgage evidences the fact that the obligation rests on the property.[2] In the preceding section, for example, where we assumed that the interests of *C* and *D* in the property were wiped out by the foreclosure action brought by *B*, *A* would still be liable to *C* and *D* on the personal obligation expressed in the notes or bonds that accompanied the mortgages.

If the mortgagee sells his right against the mortgagor he transfers to the purchaser both instruments. Corporate mortgages, covering as they do complex assets and an intricate organization of earning power, are very long. The mortgage of the Great Northern Ry. Co. for $500,000,000 contains about 50,000 words and has the appearance of a formidable book. It would seem for these reasons alone that the corporation would not care to issue mortgages to each of its bondholders, numbering perhaps tens of thousands. But there is really a more vital reason why the mortgagor company does not issue a mortgage direct to each of its mortgagees—to each of its bondholders—and that is, that while it makes many agreements in the mortgage to protect these bondholders, it does not want to have to deal with each one separately, for each, separately, might place a different interpretation on the agreements and chaos would be the result of negotiations in respect thereto. For these several reasons, then, the general corporate mortgage is made out to a trustee or trustees who represent all the bondholders, however that

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[1] See C W Gerstenberg, "Materials of Corporation Finance," pages 176 and 180

[2] If the mortgagor sold the property *subject to* the mortgage, the mortgagor would still remain primarily liable, but of course the purchaser, that is, the new owner, would get the benefit of the payment of the mortgage and would ordinarily pay the mortgage on the due date If he did not pay it and the mortgage were foreclosed, the original mortgagor would be liable for any deficiency in case the proceeds of the foreclosure sale were insufficient to pay the foreclosure costs plus the amount of the mortgage with unpaid interest. Where the purchaser of the property takes it *assuming* the mortgage, not only his property but he himself becomes liable for the debt.

body may be constituted at any time. These instruments thus made in favor of trustees are sometimes called corporate deeds of trust. It should be noticed, however, that while every corporate mortgage is a deed of trust, not every deed of trust is a mortgage. The point is that when a corporation issues unsecured bonds, or debentures,[3] as they are called, it usually makes various promises in respect to the way its business shall be conducted, and these promises are contained in a trust agreement with one or more trustees for the benefit of all the bondholders.

Trust Indenture Act of 1939.—All mortgages, deeds of trust, and other indentures under which bonds, notes, and other evidences of indebtedness are issued are subject to the Trust Indenture Act of 1939, unless exempted.[4] This Act, which is administered by the Securities and Exchange Commission, provides in substance that if the securities to be issued under the indenture are required to be registered under the Securities Act of 1933,[5] registration will not be permitted to become effective unless: (1) the indenture meets the requirements of the Act; (2) the registration statement contains certain information with regard to the qualifications of the trustee; and (3) the registration statement and the prospectus contain an analysis of the important provisions of the indenture. The Act also applies to bonds, notes, and other evidences of indebtedness issued in exchange for other securities of the same corporation, or under a reorganization plan approved by a court, which are not required to be registered. As to these securities there are three requirements: (1) the indenture must be "qualified" if the securities are publicly offered through channels of interstate commerce or the mails—that is, the indenture must conform with the Trust Indenture Act; (2) the prospectus relating to such securities must include or be accompanied by an analysis of the important provisions of the Act; (3) the securities

[3] In England the term debenture is used to refer to the whole class of bonds; in other words, Englishmen speak of debentures where Americans speak of bonds.

[4] Securities exempted from the provisions of the Securities Act of 1933 (see page 359), with a few exceptions, are exempt from the Trust Indenture Act. Certain small issues are also exempt. For detailed list of exemptions, see Prentice-Hall Securities Regulation Service.

[5] See page 358 *et seq.* for requirements as to registration under the Securities Act of 1933.

publicly offered for sale must be preceded or accompanied by such analysis.

To conform with the Act, the indenture must contain certain prescribed provisions, the most important of which are the following:

1 It must name a financially responsible corporate trustee whose interests do not conflict with those of the indenture security holders It may also name individual co-trustees

2 It must provide that where certain defined conflicting interests arise, the trustee must either resign, remove the conflicting interest, or notify security holders, and that the latter possess certain powers of removal

3 It must require the corporation to furnish the trustee with lists of security holders at stated intervals

4 It must require the corporate trustee either to make such lists of security holders available to security holders, or to mail communications from security holders to other security holders, or apply to the Commission to be excused from doing so

5 It must provide for annual reports and certain interim reports to security holders by the trustee

6 It must require the corporation to file annual reports with the trustee and to furnish the trustee with (a) evidence of recording of the indenture, (b) evidence of compliance with conditions precedent relating to issuance of additional securities and to other matters of interest to security holders, and (c) certificates of independent engineers, appraisers, or other experts, or opinions of officers of the corporation, as to the fair value of property or securities released from the lien of the indenture, and of securities or property deposited with the trustee as the basis of issuance of securities, the withdrawal of cash, or the release of property or other securities subject to the lien of the indenture [6]

7 It must require the trustee to notify the security holders of all defaults unless otherwise provided

8 It must provide that in case of default the trustee shall exercise the rights and powers vested in it with the care and skill that a prudent man similarly situated would exercise

Some of the principal duties of the trustee will be explained after the following discussion, which is given to clarify the usual procedure in connection with the issue of bonds under a corporate mortgage

Senior, junior, and underlying mortgages.—Several expressions popular in financial parlance may be explained here. A mortgage is said to be a junior mortgage when it is subordinate in lien to one or more prior mortgages. Conversely, a senior mortgage is one which is followed by one or more subsequent mortgages. The term "underlying" is applied usually to a small mortgage which has a lien prior to a larger mortgage. This situation usually arises through the expansion of a corporation or through consolidation of several corporations.

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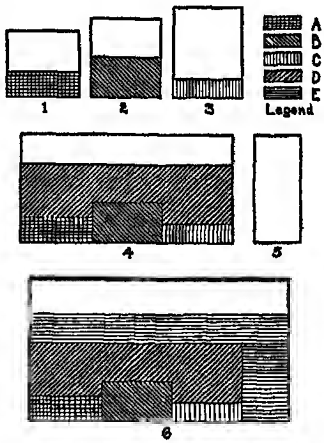
[6] See footnote 13, page 217.

The group of diagrams on this page will serve to illustrate a typical situation Let us assume that three companies, 1, 2, and 3, were organized in the same line of business at different times, and in the course of growth placed mortgages *A*, *B*, and *C* upon their respective properties, and that they then consolidated into company 4, the consolidated properties being valued at somewhat in excess of the separate values of the three companies. Later, company 4 placed mortgage *D* on its property Then corporation 6 was organized as a consolidation of company 4 and company 5, which latter company had no mortgage on its property. Company 6 then placed mortgage *E* on its properties.



Methods by Which Successive Mortgages are Imposed on Consolidated Properties

Company 4 would probably call the *D* mortgage a first consolidated mortgage, because although it was not a first mortgage on the property, it was the first mortgage which the consolidated company put on its consolidated property. Mortgage *E* of company 6 would probably be called a first and consolidated mortgage It actually has a first lien on part of the property, that which was brought into the company by company 5. In company 6, mortgages *A*, *B*, and *C* would be called underlying mortgages. Mortgage *D* is junior to mortgages *A*, *B*, and *C*, and, to a certain extent, senior to mortgage *E*. Because *E* has a direct first lien on a part of the property—probably an important part of the whole company—it would hardly be called a junior mortgage. The term "gen-

eral" would be more appropriate and would more frequently be used. The term "blanket mortgage" is sometimes used for such a mortgage as *E*, and indicates a mortgage on all a company's property, owned at the time or to be thereafter acquired.

Prior lien bonds, adjustment bonds, and receiver's certificates.[7]—In a previous section we pointed out that a corporation does well to keep its best security till the last. A company may have placed several mortgages and may be in need of more funds. Even the mortgage bondholders may recognize that new money is necessary to keep the business going and thus protect the interests of everybody. If the bondholders will consent, a new mortgage may be placed on the property prior in lien to all other mortgages, or with the consent of junior bondholders, prior to the junior mortgages. Bonds issued under such prior lien mortgages may then be called prior lien bonds. Prior lien bonds are rare, because it is difficult to get the consent of bondholders having claims under older mortgages.

Sometimes a corporate mortgage provides immediately that other bonds under other mortgages may be issued subsequently, but with a lien prior to that of the former mortgage. Such a mortgage is likely to be made in case of reorganization or of readjustment of the company in time of difficulties, and the bonds issued under it will therefore be called adjustment bonds. An example is the adjustment 5's of 1949 of the Seaboard Air Line Railway.[8]

In time of adversity, when a company is in the hands of a receiver, the court appointing the receiver may direct him to raise money by selling receiver's certificates. These certificates will have a lien on the property wherever the court places it; frequently its lien comes prior to those of some or all of the older mortgages.[9]

Mortgages on after-acquired property.—Ordinary real estate mortgages, as we have seen, cover specific property, while the general corporate mortgage covers all the property of the corporation (including in the case of utilities the special

[7] See chapters on reorganization.

[8] Illustrations of the various bonds described in this chapter will be found in "Fitch Bond Descriptions."

[9] Further discussion of the use of receiver's certificates is reserved for the chapters on reorganization.

franchises), future earnings, and future acquired property, or, as it is generally expressed, after-acquired property The purpose of the corporation is to mortgage everything it has, to give the amplest security, and thus to reduce the rate of interest that will have to be paid on the bonds.

The importance of this after-acquired clause cannot be overestimated. It has a most important effect upon methods of corporate financing. Its main purpose, we said, is to give everything over to the bondholders, what is owned and what is to be acquired—body and soul. This will make the bonds sell easily. Later, when new property is acquired, if the acquiring is done in the ordinary way the mortgage will become an immediate lien upon it If, now, the company should wish to pay a part at least of the purchase price of this new property out of the proceeds of bonds secured by another mortgage on the new property, these new bonds would not be rated very high since the lien of their mortgage would be subordinate to that of the original corporate mortgage whose lien, by virtue of the after-acquired clause, would have rested on the property as soon as it was acquired. Just how corporations repent their bargains made in after-acquired clauses is a matter that we shall study later.[10]

Purchase money mortgages.—A purchase money mortgage is one given in whole or part payment of the price of the property on which it rests. Thus, if *A* buys property *X* from *B* for $15,000, paying $5,000 cash and giving back a mortgage on property *X* for $10,000, this mortgage will be called a purchase money mortgage. What, it may be asked, is the peculiar nature or effect of a purchase money mortgage? What, in effect, have the parties to this transaction done? *B*, we may suppose, with his right hand has conveyed the title to property *X* to *A* by giving *A* a deed; with his left hand *B* has taken back the legal title to property *X* by means of the mortgage. What has *A* really got? Nothing but the equitable title—the equity of redemption. And now if *A* happens to be a corporation with an outstanding general mortgage containing an after-acquired clause, what will be the relative positions of the general mortgage and the purchase money mortgage in respect to property *X*? Is it not evident that the purchase money mortgage has the first lien? The after-

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[10] See pages 228 *et seq*

acquired clause, to be sure, operates as a mortgage on X, but only on so much of X as A owns, which, as we saw, was the equity of redemption behind the purchase money mortgage

Closed-end and limited open-end mortgages.—Corporate mortgages covering the entire property of a company may be (1) closed-end, (2) limited open-end, and (3) open-end This classification has reference to the amount of indebtedness secured by the mortgage. If the entire issue of bonds secured by a mortgage has been disposed of, so that if more bonds are to be issued and secured by mortgage on the same property they must come under the lien of a subsequent mortgage, the earlier mortgage is said to be closed In case of foreclosure, and in the absence of a special subsequent agreement, all the bonds under the mortgage first issued must be treated alike and must be paid in full before bonds under the later mortgage can participate in the proceeds of the property.

Under most modern corporate mortgages, however, provision is made for future financing. The mortgage is usually a limited open-end mortgage; this means that the equitable rule that "priority in time gives priority in equity" is waived and that all bonds issued under the mortgage, whenever issued, share alike in the proceeds of the foreclosure. The term "limited" is used, since a stated amount of indebtedness may be ultimately secured by the mortgage, but this limit cannot be exceeded.

Thus, if a company knew that it would need $4,000,000 in the next two years and later would use $6,000,000 for other additions, it would not execute a mortgage now for $4,000,000 and sell the bonds thereunder, and later execute a mortgage for $6,000,000, for if it did that, the $6,000,000 issue would have a subordinate lien; the holders of the bonds secured by it would not be entitled to share in the property till the $4,000,000 issue had been paid off. In consequence, under such an arrangement the second mortgage bondholders would demand a high rate of interest. The company therefore would execute at present a limited open-end mortgage for $10,000,000, providing that when bonds in addition to the first $4,000,000 are issued they will share *pari passu*, that is, alike with, the $4,000,000 bonds first issued. Thus, if an additional $1,000,000 were issued, say in the third year, the situation would present a first mortgage of $5,000,000 and not a first mortgage of $4,000,000 and a second mortgage of $1,000,000.

TABLE No 4

LIMITED OPEN-END MORTGAGES OF SOME OF THE LARGE RAILROADS

Issue	*Authorized*	*Outstanding in Hands of Public*	*Held in Treasury*	*Pledged*	*Reserved for Prior Liens*	*Reserved for Future Betterments*
Seaboard Air Line, First and Con Mtge 6's, Ser "A," due September 1, 1945	$300,000,000	$ 61,997,500	$1,608,000	$ 22,976,500	$ 70,185,000	$143,233,000
Illinois Central R R -Chicago, St Louis & New Orleans, Joint First Refunding Mtge Gold Ser "A" and "B" 5's, and Ser. "C" 4½ s, due December 1, 1963	120,000,000	64,390,475		3 820,000	50,135,525	1 654,000
Baltimore & Ohio, Refunding and General Mtge Ser "A" 5's and "B" and "C" 6's, due December 1, 1995, Ser D" 5's, due March 1, 2000 and "F" 5's due 1996	600,000*	158,120,750	4,000	102,147,250	267,279,200	72,448,800
Erie Railroad, Refunding and Improvement Mtge Gold 5's, Ser of 1927, due May 1, 1967, Ser of 1930, due April 1, 1975, Ser of 1932, due 1962	644,604,300†	100,000,000	3,400,000	31,600,000	?	?
Southern Railway Co Development & Gen Mtge Gold 4's (and 6½'s and 6's) Ser "A," due April 1, 1956	200,000,000	111,333,000	.	42,769,000		45 898,000‡
Chicago & Northwestern Ry Co Gen Mtge Gold 3½'s, 4's, 4½'s, 4¾'s, and 5's due Nov 1, 1987	165,000,000	132,016,500	3,500	23,896,000		9,084,000

* While limited to three times the outstanding stock, limit is regarded by issuer as $600,000

† Limited to three times the outstanding capital stock, based on stock outstanding Dec 31, 1937

‡ Reserved for additions and betterments and certain prior liens

When the whole $10,000,000 are issued, the mortgage will be said to be closed.

On page 213 is a table of large limited open-end mortgages, showing the ultimate limit and the amount outstanding (1938)

Bonds issued in series but protected by a single mortgage.—These blanket mortgages under which issues are made from time to time, frequently provide that the directors may decide as each issue is made, the term of the bond, the rate of interest, and the nature of the bond, that is, whether it is to be registered, or coupon, or interchangeable The following abstract of the general mortgage of the Pennsylvania Railroad, dated June 1, 1915, taken from the White & Kemble bond descriptions, illustrates the point exactly.

> The bonds issued or to be issued and secured by this mortgage are to be issued in series, bearing various rates of interest, and maturing at various dates, but no bond shall be issued to mature prior to the date of maturity of any of the prior lien bonds mentioned in the mortgage or any bond issued and then outstanding, secured by this mortgage All bonds of one and the same series shall be substantially identical in respect of the date of maturity, the rate of interest, the place or places of payment, which may be in a foreign country, the currency or currencies in which the same are payable, and as to the privilege, if any, of exchangeability into other bonds or of convertibility into stock, and as to the terms of redemption, if redeemable, but in respect to these and other features, the bonds of one series may differ from those of another series

Further illustrations of variations in different series are furnished by the Cleveland & Pittsburgh R. R. Co. General (First) Mortgage Sinking Fund Gold 4½'s and 3½'s, and the New York, Chicago & St. Louis R. R. Co. refunding gold 5½'s Series A, and gold 4½'s Series C.

Closing limited open mortgages.—Very frequently, as may have happened in the case assumed above, where future needs were estimated at $6,000,000, the limit is set too low, subsequent events show a rate of growth much more rapid than was expected and the limited mortgage proves a stumbling block to much larger financing. In such an event two methods of procedure are open. One is to negotiate with the holders of the bonds to refund their holdings into a much larger issue. If all the bondholders consent to the refunding, the old, relatively small mortgage is extinguished and the new, larger mortgage provides a first lien to cover the new bonds to be sold. If, on the other hand, the bondholders will not con-

sent, the new mortgage may be issued, and a clause may be inserted in it providing that no more bonds may be issued under the terms of the earlier mortgage, which, though it remains a first mortgage, is limited in size to less than was originally contemplated

As an example of the former method we find the execution in 1909 of a $30,000,000 mortgage by the Jones & Laughlin Steel Co., when only slightly over $2,000,000 of a $10,000,000 earlier mortgage had been issued. The company negotiated with the holders of these $2,000,000 of bonds, and probably with some special inducement, got them to accept bonds of the $30,000,000 issue in their place. In this way the $30,000,000 mortgage was given the first lien [11] Many examples of the latter method of disposing of early underlying mortgages will be found in railway finance. See, for example, the First Mortgage 4's of 1950 of the Indiana, Illinois & Iowa Railroad Co., which was executed for an authorized limit of $12,000,000, but which was closed at $4,850,000 The aggregate principal amount of Washington Railway & Electric Company consolidated mortgage 4% fifty-year bonds, due 1951, which may be issued under the indenture is $17,500,000. However, the Washington Railway & Electric Company has covenanted, in an agreement with Capital Transit Company, a subsidiary, to limit the issue to $7,118,100.

Open-end mortgages.—The open-end mortgage is one which covers all bonds to any amount thereafter issued under the provisions of the mortgage. If a company could issue additional bonds from time to time under cover of such a mortgage, the earlier purchasers of bonds would be injured unless, as new bonds were issued, the security itself were in some way increased. Thus, if a company had a plant worth, say, $1,000,000, and had issued, under an open-end mortgage, bonds for $600,000, there would be an equity back of those bonds equal to 40 per cent of the value of the property. If, now, without addition to the property, more bonds are issued, the equity will be "thinned down." On the other hand, if the company retained its earnings instead of passing them out as dividends to its stockholders, and thus increased the value of its property to $1,200,000, a new issue of bonds secured by the same mortgage could be made without injuring the $600,000 of bonds, provided, of course, the same per-

[11] See C. W. Gerstenberg, "Materials of Corporation Finance," pages 196–197, Section 1.

centage of equity were established in the new property as existed in the old. Thus, $300,000 of new bonds might readily be offered for cash at par without affecting the equity. We shall see later that in practice this building up of property by reinvesting earnings is only one of many methods of protecting old bondholders under open-end and limited open-end mortgages. But now we simply want to point out that if protection *is* afforded, there would seem to be no reason why mortgages should not be made open-end. An ideal situation for open-end mortgages is found in the case of public service corporations. In such cases there are not only the provisions of the mortgage itself to prevent the issue of additional bonds unless the company has additional property and earning power, but there is also the public service commission with ample authority minutely to investigate proposed security issues [12] Indeed, it is the plain duty of a commission to see that new bonds under an open-end mortgage are not issued unless the company has ample security in assets (that is, in liquidating power) and in income (that is, in interest-paying power) for both the old and new issues Thus the tendency in public utilities is in the direction of utilizing open-end mortgages. To cite one of many examples, the Peoples Gas Light & Coke Co First and Refunding Mortgage 4's, Series "B," due 1981, are issued under an open-end mortgage.

Authentication of bonds.—In a previous paragraph we said that we would explain some of the duties of trustees in corporate mortgages. We are now prepared to take up one of the most important of these duties, that of authentication of bonds. In large bond issues plates are engraved with great care for the printing of the bonds, the bonds are printed, and with proper formalities to see that no spurious blanks are improperly circulated they are placed in the custody of the trustee, who has instructions in the mortgage as to the terms and conditions under which the bonds may be issued. Let us follow the transaction through and suppose that the mortgage provides simply that the company may issue bonds in full amount equal to 80 per cent of the value of the new property acquired. We will suppose that the company has acquired a new plant worth $1,000,000, and is entitled, therefore, under

[12] Under the Public Utility Holding Company Act of 1935, the Securities and Exchange Commission has control over the issuance of securities of companies subject to the Act. For example, it may refuse to permit the issuance or sale of a security if it is not reasonably adapted to the earning power of the company, or if it is not properly secured.

the terms of the mortgage, to sell $800,000 face amount of bonds. The proper officers of the company will execute a certificate to the effect that such property has been acquired, and will attach thereto copies of the deeds to the property and a statement to the effect that the property is worth $1,000,000.[13] Ordinarily, a lawyer's opinion will accompany these papers, in which opinion the lawyer will show that the title is properly vested in the company There will also be a resolution of the board of directors authorizing the proper officers to execute and sell the bonds. When all these documents have been received, the corporate trustee will authenticate $800,000 face amount of the bonds and deliver them to the corporation to be sold. The authentication consists simply in signing a certificate usually found on the outside panel of the bond and reading as follows:

This bond is one of the bonds described in the within mentioned mortgage and deed of trust

Blank Trust Company,

By . . . .

Trust Officer

It will be noticed that this authentication does not represent the bond to be a valid obligation of the company, it does not state that the company has gone through the proper formalities prescribed by law for the issuance of bonds; it merely states that it is issued under the mortgage and therefore is as good as the mortgage is good.[14] But the certificate does protect an innocent purchaser of the bonds, even if they are wrongfully sold or pledged by an officer of the company for his own benefit.

Rights of trustees in respect to pledged securities.—Most large companies own stocks and bonds of subsidiaries, and it

[13] Under the Trust Indenture Act of 1939, the statement to the trustee as to the value of the property must be made by an independent engineer, appraiser, or other expert, approved by the trustee, if the property has been used or operated by others, within six months prior to the date of acquisition by the corporation, in a business similar to that in which it is to be used or operated by the corporation, unless the fair value of the property amounts to less than $25,000 or less than 1 per cent of the aggregate principal amount of indenture securities outstanding Where the services of an independent engineer, appraiser, or expert are not required, the certificate or opinion may be made by an officer or employee specified in the indenture.

[14] See Tschetinian v City Trust Co of N Y, (1906) 186 N Y 432; L I. Loan & Trust Co v Columbus, etc , Ry Co , (1895) 65 Fed. 455

is customary in large blanket mortgages to include these by way of pledge as part of the security. A pledge, it will be remembered, ordinarily takes place by transfer of actual possession, and to the trust company, therefore, are actually delivered the stocks and bonds covered by the mortgage. Not only is possession transferred, but actual title also, and the trustee, therefore, becomes the legal owner of the securities on the books of the subsidiary companies. Certain reservations are customarily made, namely: (1) that as long as the mortgagor company is not in default it shall be entitled to the income derived from the pledged securities, and (2) until default the trustee shall give proxies to the company in respect to pledged stock, which proxies enable the mortgagor to elect directors of its own choosing for the subsidiaries. Wherever directors so elected must qualify by holding stock in a subsidiary, qualifying shares are exempted from the pledge and placed on the books of the subsidiary company in the names of the directors.

This arrangement, it will be seen, leaves the trustee owner in its own name, but, of course, for the benefit of the bondholders whom it represents, and subject also to the temporary rights of the mortgagor above enumerated and also to the corporation's right of ultimate redemption. If the mortgagor should default, the trustee can enforce its claim against the pledge by simply asserting its right of ownership. It may revoke the proxies and may demand direct payment to it of dividends and interest paid by the subsidiaries in respect to the pledged securities

Moreover, since the trustee becomes an actual bondholder in the subsidiary company, it is usually given the rights of bondholders, so that if any of the subsidiaries default in payment of interest, the trustee may proceed against such subsidiaries to the same extent as the other bondholders.

Carefully-drawn mortgages provide against an impairment of the value of pledged securities. Consider the following situation. *P* is a parent company with a mortgage on all its property, including the stock of company *S*, its subsidiary, of which it owns, we shall say, 60 per cent. Assume that the outstanding stock of *S*, including that held by *P*, amounts to $12,000,000, and that the book value of that stock is $15,000,000. To put it another way, the property of *S* after payment of all debts is worth $15,000,000. If, now, the surplus of

\$3,000,000 were paid out in dividends, 60 per cent would go to *P* and would be added to *P*'s surplus and in that way made available to *P*'s stockholders as dividends. Were all these steps taken, including a declaration by *P* of a dividend equal in amount to the sum received from *S*, the net result would be that the \$7,200,000, face amount, of pledged stock, which at the time of the making of the mortgage was worth just \$9,000,000, would now be worth only \$7,200,000 and nothing would be found in the mortgaged or pledged assets to take the place of the vanished value, amounting to \$1,800,000. That sum would have gone to the stockholders of *P* and the bondholders' security would be impaired to just that extent. To prevent such a situation, modern mortgages usually provide that if the mortgagor receives any income from pledged securities paid by the subsidiaries out of anything but current income, such income so received shall be turned over to the trustee to be invested in property to be added to the estate securing the mortgage. On the same principle, provision is also made that stock dividends on shares pledged and moneys received in any way on account of the principal of the securities pledged, are to be held by the trustee as additional security.

Duty of trustee to enforce the terms of the mortgage.—The company, as we shall see, promises to do many things besides merely pay the interest on the bonds and redeem them at maturity, though, to be sure, these are the two chief obligations of the mortgagor. Under the Trust Indenture Act, it is the duty of the corporate trustee to see that the corporation performs its obligations. In case of default in the payment of interest and principal, the trustee is authorized to recover judgment in its own name against the corporation for the total amount of principal and interest due and unpaid.[14a] As we have seen on page 208, the trustee must be required by the indenture to exercise the care of a prudent man similarly situated in carrying out its duties, rights, and obligations under the indenture. The indenture may provide that not less than a majority of the bondholders may direct the time, method, and place of conducting any proceeding for any remedy available to the trustee.

[14a] The indenture may provide that the holders of not less than a majority of the securities outstanding may consent, on behalf of all the security holders, to the waiver of any past default and its consequences It may also provide that holders of not less than 75 per cent of securities outstanding may consent on behalf of all the security holders to the postponement of any interest payment for a period not exceeding three years from its due date.

Duty of trustee to protect mortgaged property.—The trustee is generally required to protect the mortgaged property, that is, to see that the company pays its taxes, pays the interest on underlying bonds, and keeps its property insured If any of these obligations is neglected, the trustee may perform it and will have a lien on the property for any moneys disbursed. The trustee is also given the right to release certain property from the lien of the mortgage, suitable provision being made, however, that adequate value is placed under the lien of the mortgage to take the place of the released property [14b] The company also covenants in the mortgage to maintain the value of the mortgaged estate. For a breach of this or any other covenant, the trustee may declare the principal due, and if it is not paid, may begin suit for foreclosure of the mortgage.

Covenants of the mortgagor company.—We have seen what some of the covenants are that a corporation undertakes in a general corporate mortgage. Other usual covenants may now briefly engage our attention.

First there is the usual covenant to pay the principal and interest without deduction for taxes. When a mortgage contains this covenant, the bonds issued under it are said to be "tax-free" or "tax-exempt," though this latter term should be reserved for such bonds as those issued by public corporations, which are exempt from taxation under the law. Ordinarily, the wording of the covenant, together with the wording of the law and the regulations of the government, do not make these bonds wholly free from taxation, but free up to a certain percentage of the interest only, which percentage the company agrees to pay to the government for the bondholders. The bondholder, of course, pays the rest of the tax himself.

The company usually agrees to comply with the rules necessary to make the bonds listable on the stock exchange.

The company usually agrees to record the mortgage wherever it is necessary to record it in order to bring the company's property under the lien of the mortgage. Evidence of recording is required to be filed with the trustee. See page 208.

Frequently, the company will covenant not to pay dividends unless its assets, both fixed and liquid, are so abundant

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[14b] See page 208 for requirement under the Trust Indenture Act as to certification of value of substituted property

that there is little danger of the company's subsequent failure. In the Jones & Laughlin Steel Co. mortgage, for example, the following provisions will be found:

> The Company covenants and agrees that the surplus of quick assets over the liabilities of the Company other than the outstanding bonds issued under this indenture shall always equal at least $8,000,000 so long as the said outstanding bonds shall equal or exceed $8,000,000, and covenants and agrees that said surplus of quick assets over liabilities shall always equal the amount of bonds outstanding so long as the face amount of the bonds outstanding shall be less than $8,000,000. By the phrase "quick assets" is meant cash in banks, on hand and in transit, good accounts and short-time bills and notes or similar securities received on the sale of products, raw material, material in process of being manufactured, manufactured products and supplies (it being understood that all material, manufactures and supplies shall be figured at the market value thereof at the time of the valuation thereof hereunder). It is expressly understood and agreed that in the term "raw material" no ore, coal or limestone shall be included except such as has actually been mined or quarried and is then on the surface at the mines or at the quarries, available for shipment, or in transit, or at docks or at works, and in no case is raw material to be held to include unmined minerals. The Company further covenants and agrees that the net assets of the Company are and shall always be at least $25,000,000 in excess of the par value of the present capital stock of the Company, such par value of the present capital stock of the Company being $30,000,000.

The last sentence in the above paragraph, it will be noticed by one who has any acquaintance with accounting, is similar in effect to a clause that might be worded thus: "The company covenants and agrees to maintain a surplus of $25,000,000." The effect is to limit dividends. Sometimes the same result is obtained by providing that dividends may not be paid out of previously accumulated profits and that thereafter a certain proportion of the property must be turned into an improvement fund.[15]

Restrictions in open-end mortgages.—We have seen how open-end or limited mortgages are used in modern financing. To some of the dangers of the open-end mortgage we have already referred. The problem may best be illustrated by diagrams. See Figs. 1 and 2, page 222. Assume that a company with property *A*, which is worth $10,000,000, has issued $6,000,000 of bonds under a $30,000,000 mortgage. The situation would appear somewhat as follows, where the

[15] See page 302 for illustrations of provisions for improvement funds.

parallelogram in Fig. 1 represents property *A*, and the shaded portion the mortgage.

The equity now is equal to 40 per cent of the security. If you had purchased one of the $6,000,000 worth of bonds with a face amount of $1,000, there would be property of a value of $1,667 to protect your bond. If more bonds were issued without increasing the value of the property, the amount of security behind your bond would diminish. Thus, if $2,000,000 were issued, the security ratably behind your bond would be worth only $1,250.

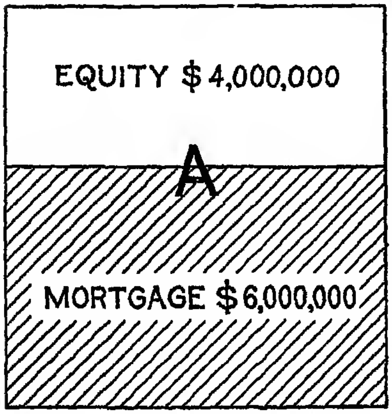

Fig. 1.

Suppose, on the other hand, more property were acquired, say $2,000,000 worth, represented by *B* in Fig. 2. Suppose further that this property were bought with $2,000,000 of bonds of the same issue. The result now would be that a security of a total value of $12,000,000 was protecting $8,000,000 of bonds. The equity would be only 33⅓ per cent and each bond would be protected by property worth only $1,500. The equity has fallen from 40 per cent to 33⅓ per cent and the security behind the bond has fallen from $1,667 to $1,500. Evidently some plan must be devised to protect investors who buy bonds under an open-end or a limited open-end issue. The provisions in a mortgage designed to accomplish this purpose are called restrictions, because they restrict the issue of bonds in one way or another. Sometimes they are called escrow agreements, because they recite the terms on which the unissued

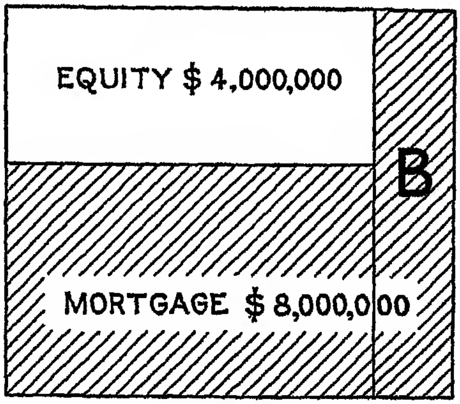

Fig. 2.

bonds held by the trustee in escrow can be released from the escrow. These restrictions must now engage our attention.

Issue of bonds restricted to a certain proportion of new property.—Evidently the way to meet squarely the problem presented in the foregoing paragraph is to provide that no bonds shall be authenticated by the trustee unless new property is acquired by the company to thicken the equity, that is, to increase the security. The plan followed in such cases has already been described (see page 215). The usual provision is that bonds may be issued for an amount not exceeding 80 per cent of the cost or value of permanent improvements, additions, or extensions, or any new or additional property constructed subsequent to the date of the mortgage. Sometimes, though rarely, the escrow agreement provides that bonds may be issued up to the full amount of the property acquired. Such a provision is found in the Jones & Laughlin Steel Co. mortgage [16]

But it is likely that where such an apparently inequitable arrangement is permitted, other protecting clauses will be added, unless special circumstances justify issuance of bonds up to the full value of property newly acquired. For example, in the case of the Jones & Laughlin Steel Co., the original property was adequate to support the entire issue of bonds, provided new property was added equal in value to the amount of bonds issued [17] Moreover, a clause in the mortgage provided that whenever additional bonds were requested to pay for new property acquired, the directors were to certify that property theretofore acquired and made the basis of an issue under the mortgage had not decreased in value. Thus, each time new bonds are issued under such a mortgage it becomes necessary to inquire into the condition of the old security as well as into the value of the newly acquired property.[18]

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[16] See C W. Gerstenberg, "Materials of Corporation Finance," pages 197 *et seq*

[17] The bond circular announcing the sale of original bonds under that mortgage stated that $20,000,000 had been added to the plants in the two preceding years The entire amount of the mortgage was only $30,000,000, of which $15,000,000 apparently was to be used principally for paying off floating debt, while the other $15,000,000 was to be issued to the extent that the new property was acquired. Assuming that the old plants before the improvements of the two preceding years had been made were worth $15,000,000, the entire issue of bonds of $30,000,000 would have had a total security of $50,000,000.

[18] An example of a somewhat similar restriction is found in the mortgage securing the Consolidated Mortgage 4's of 1990 of the Manhattan Railway

A restriction found in mortgages not of recent date is that which limits the number of bonds that can be authenticated and issued at a given time. The large refunding mortgage of the Great Northern Ry. Co., (now closed) limited the amount to be issued in any year to $1,000,000. The Bethlehem Steel Company's First Lien and Refunding Mortgage, dated May 1, 1912, provided that not more than $5,000,000 of the bonds secured by the mortgage could be issued at one time. Sometimes, as in the case of the St. Louis Southwestern Ry First Terminal and Unifying Gold 5's, where the rate of issue for additions and betterments is limited to $300,000 annually and for new equipment to $500,000 annually, the amount is cumulative. That is, any portion of such bonds not issued in one fiscal year may be issued at any time thereafter in addition to the amount allotted to the year in which the portion is so spent. There is little to commend such provisions, and in mortgages of the last decade they are rarely found.

Protection of future interest.—Two restrictions are frequently placed in corporate mortgages, the purpose of which is to see that the interest on bonds already issued will not be jeopardized by demands for interest made by bondholders acquiring bonds subsequently.

The first restriction to protect the interest on bonds is frequently added in some such terms as these: Bonds shall not be authenticated for issue if the net earnings applicable to the payment of interest for twelve consecutive months out of the fifteen preceding are not equal to or greater than one and three-quarter times[19] the amount of the bond interest that will be payable when the proposed new issue is made. Thus, if a company has $6,000,000 bonds outstanding and wishes to issue $1,000,000 additional bonds bearing interest at 5 per cent to finance the construction of property, the amount of

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Co, the provision being that bonds may be issued for extensions at the rate of $300,000 for single track and $600,000 for double track These bonds were issued in 1890. It was very unlikely that $300,000 would be a fair rate—not too much or not too little—over an entire century This mortgage is now closed

Sometimes the mortgage provides that bonds shall not be issued beyond a certain proportion of the value of the property Thus the First Mortgage 4's of the Boston Wharf Co are protected by a provision in the mortgage that the mortgage shall be limited to an amount equal to only 50 per cent of the assessed valuation of all the company's real estate

[19] This multiplier, of course, may be higher; one and three-quarters, however is a very usual multiplier

interest required, assuming the $1,000,000 to be issued, will be $350,000 a year. Unless, then, its net earnings are equal to or in excess of $612,500, the new bonds cannot be issued. Frequently, a provision is included that in calculating net earnings at least 5 per cent of gross revenues must be charged to operating expenses for repairs and current maintenance.

The second restriction, which is much less common than the first, may be stated briefly as follows: New bonds are not to be issued if the aggregate fixed charges after they are issued exceed a certain proportion of the net quick assets. The careful reader will see that this is but another way of saying that net quick assets must be sufficient to pay the fixed charges, including the interest on the bonds proposed to be issued, for a certain number of years. Thus, if the net quick assets of a concern are $1,000,000 and bonds outstanding amount to $10,000,000 and it is proposed to issue $5,000,000 more, the net quick assets would be sufficient to pay interest on the bonds, assuming they were 5 per cent bonds, for one and one-third years. This ordinarily is not sufficient Similar to this restriction is the one calling for maintenance of a certain ratio between current assets and current liabilities. Usually restrictions of this kind carefully define what is meant by net quick assets, or current assets and current liabilities.

CHAPTER XIII

FINANCING WITH MORTGAGE BONDS

Extent to which financing is done with bonds.—An idea of the extent of borrowing as compared with financing through the sale of stock may be gained from the following table, compiled from balance sheets submitted by corporations with their income tax returns [1]

CAPITALIZATION OF CORPORATIONS IN THE UNITED STATES

Funded debt	32 7%
Preferred stock	12 9
Common stock	54 4

Certain classes of corporations, such as railroads and public utilities, depend upon borrowing to a greater extent than is indicated in the above table. For example, at the close of 1936, according to the Interstate Commerce Commission, the capitalization of operating railroads, not including switching and terminal companies, was made up as follows·

CAPITALIZATION OF RAILROADS IN THE UNITED STATES

Funded debt	55 1%
Preferred stock	10 1
Common stock	31 8

Comparable figures are not available for all industrial corporations or for public utilities.[2]

The extent of borrowing during recent years, as compared with financing through new issues of stock, is indicated on page 227. The table shows year by year, for railroads, public utilities, and industrials (including investment trusts), the relative amounts of stock, notes, and bonds, expressed as percentages, issued for various corporate purposes, excluding refunding issues. From the table it is apparent that prior to 1928 corporations sold considerably more bonds and notes to the public than stock. During 1928, and until the stock

[1] From *Statistics of Income for 1930*, Bureau of Internal Revenue

[2] The publication mentioned in footnote 1 shows the capitalization of various classes of industrial corporations and also indicates the capitalization of transportation and public utility companies as a group.

The Bureau of Business Research of the College of Commerce and Business Administration of the University of Illinois has made a study of the financial plans of several classes of public utilities and industrial companies which shows for such companies the extent of borrowing in relation to other methods of raising capital. The results of the study are published in pamphlet form

TABLE No 5
NEW CAPITAL ISSUES—PERCENTAGES OF STOCKS, NOTES, AND BONDS

	1938			1937			1936			1935		
	Long Term Bonds and Notes %	*Short Term Bonds and Notes* %	*Stocks* %	*Long Term Bonds and Notes* %	*Short Term Bonds and Notes* %	*Stocks* %	*Long Term Bonds and Notes* %	*Short Term Bonds and Notes* %	*Stocks* %	*Long Term Bonds and Notes* %	*Short Term Bonds and Notes* %	*Stocks* %
Railroads	100 0	0	0	98 1	1 9	0	92 8	7 2	0	100 0	0	0
Public Utilities	97 4	7	1 9	93 5	2 3	4 2	95 3	1 0	3 7	97 9	0	2 1
Industrials and Investment Trusts	89 3	3	10 4	47 3	4 8	47 9	55 6	3	44 1	68 1	4 6	27 3
Total	92 1	4	7 5	62 8	4 0	33 2	67 9	1 9	30 2	80 0	2 8	17 2
	1930			*1929*			*1928*			*1927*		
Railroads	90 2	1 5	8 3	71 7	4 0	24 3	82 2	3 4	14 4	78 1	3 8	18 1
Public Utilities	56 0	11 7	32 3	33 9	2 5	63 6	51 9	6 3	41 8	58 5	4 0	37 5
Industrials and Investment Trusts	44 7	15 0	40 3	21 0	2 2	76 8	39 7	2 4	57 9	71 2	5 9	22 9
Total	57 5	11 3	31 2	27 2	2 4	70 4	45 9	3 6	50 5	67 0	5 0	28 0

From compilations of the *Commercial and Financial Chronicle* The years 1931–1934 are omitted to make room for 1927–1930, which are more significant for purposes of this discussion

market crash in the fall of 1929, the illusion existed that the equity in stocks was of such value that the stocks could keep rising forever, with the result that an extraordinary amount of financing was done through the sale of stocks, especially common stocks [2a] With the decline in the stock market, bonds again came into favor as a means of new financing.

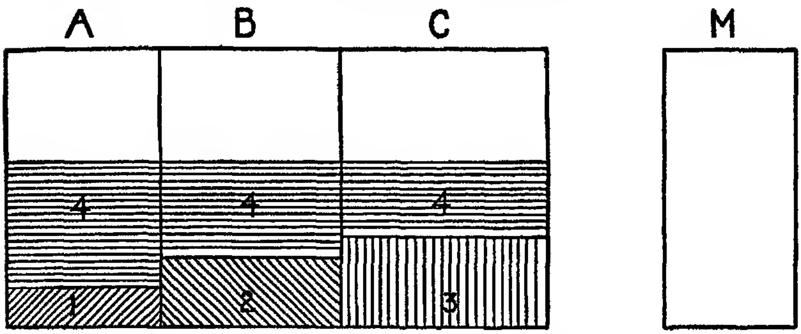
Methods of modern bond financing.—Looking into the financial history of railroads, one can see that in years gone by the financial policy of companies did not always take into consideration some of the broad principles of borrowing set forth in Chapter X. Hand to mouth financing—catch as catch can—was the order of the day. Financial needs were not anticipated; moreover, economy could not be practiced since corporations usually were of limited size. As the corporate unit has grown, various readjustments in financial plan have been necessary to reduce to a minimum the annual cost of capital assets. The chief process by which this has been accomplished has been the amalgamating of bond issues into single large issues.

The after-acquired clause bugaboo.—Corporations, it must be remembered, are but the creatures of human devices and partake of all the human frailties. Most of us have enough of the devil in us to live up to the adage: "When the Devil was sick,—the Devil a monk would be; when the Devil was well,—the devil a monk was he." When corporations have needed money they have been willing to mortgage not only their bodies, but their souls, if we may apply that term to the earning power which is reflected in the after-acquired property of a corporation. Instead of keeping their best security to the last, corporations have seen to it that not even new property shall be available as security for new bond issues. The difficulty that has arisen from modern bond financing—the subjection of after-acquired property to the lien of a previously issued mortgage, so that if bonds are to be sold secured by the new property they will have a subordinate lien and therefore will have to bear a high rate of interest—this difficulty, we say, has been solved in several different ways. These we shall simply mention here, and then we shall proceed to explain each carefully.

[2a] A study of the capitalization of 184 leading industrial corporations made in 1930 by Professor Harry G Guthmann of Northwestern University, based on 1922, 1925, and 1928 figures, led to the conclusion that there was an unchanging proportion of funded debt and a declining proportion of preferred stock, balanced by a rise in the common equity. See *Annalist*, May 16, 1930.

1. Purchase money mortgage principle.
2. Subsidiary company to acquire new property.
3. Lease of new property instead of direct purchase.
4. Closing out effects of after-acquired clause by consolidation of corporation with other companies.

An imaginary example.—We have spoken of certain difficulties and problems that arise in corporate financing from piecemeal growth and from the practice of using after-acquired clauses in corporate mortgages. Let us now make the problems more concrete by taking an imaginary example.



Financing Acquisition of Property
(See Text)

We shall suppose that company *ABC* (see diagram) is a consolidation of three companies, *A*, *B*, and *C*, each of which had a mortgage on its property before consolidation, said mortgages being represented respectively by the portions of the diagram designated 1, 2, and 3 and being in amount, respectively, \$1,000,000, \$2,000,000, and \$3,000,000. *ABC*, shortly after consolidation, issues bonds under limited open-end mortgage 4, the full amount of which is \$10,000,000 Various additions have been made to the property, entailing the issue to date of \$6,000,000 of the number 4 bonds. Mortgage 4 has an after-acquired clause. The company now wishes to acquire property *M* at a cost of \$5,000,000. Evidently this cannot be done with number 4 bonds since only \$4,000,000 are left. Moreover, if the number 4 bonds are used, future financing will have to be done under a subsequent mortgage and therefore at an increased rate of interest.

What should the company do in order to obviate this difficulty?

1. It should try to consolidate its underlying issues. They were placed on the property when the companies were new, before their credit was well established, and at a time, therefore, when comparatively high interest rates had to be paid.

2. The company must get property *M* with funds bearing the lowest interest rate possible.

3. The company must provide means for financing expansion in the future at a known and reasonable cost

First refunding mortgages.—All of these purposes can be accomplished by a large, so-called first refunding mortgage [3] If the company will abandon mortgage 4 (or provide in a new mortgage that mortgage 4 shall be closed at $6,000,000) and then execute a new reasonably large mortgage—sufficiently large to take care of all probable needs for say from thirty to fifty years, if that is to be the term of the new mortgage—purpose number three stated above will be accomplished.

Use of purchase money mortgage device in acquiring new property.—A second problem company *ABC* has on hand is to get property *M* with funds at a low rate of interest Interest, we saw, depends on risk, and if risk can be minimized by giving good security, the interest rate may be reduced. Obviously, nothing better, for the present at least, than a third mortgage can be given on properties *A*, *B*, and *C*, and on account of the after-acquired clause in mortgage 4 it would seem that the best lien that can be given on the new property, *M*, is a second lien. But here is where the purchase money mortgage principle, already described (see page 211) comes in. The plan to be followed may be illustrated as on page 231.

In the diagram, circle *C* stands for a so-called construction company,[4] which holds title to property *M*. The title is transferred to the company and at the same time *C* takes a purchase money mortgage from *ABC*.[5] This mortgage is

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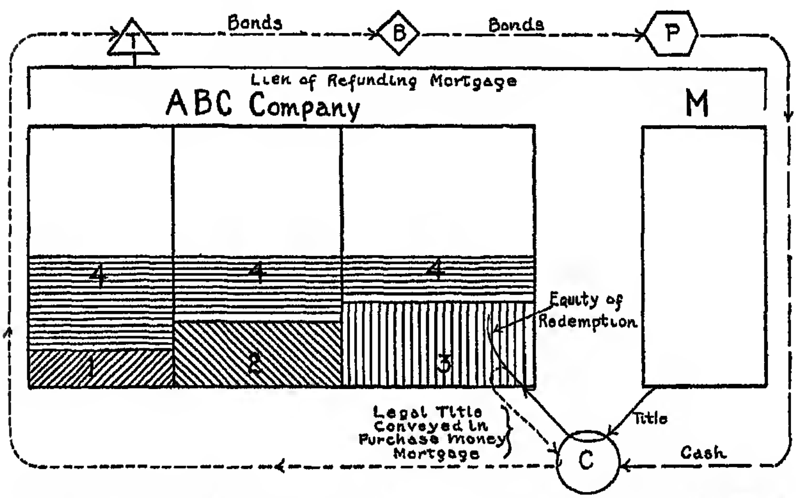
[3] If in addition to mortgage 4, any of the underlying mortgages were refunded, the bonds would probably be called "first and refunding"

[4] A better name is finance company For a description of well-known construction companies, see W Z Ripley, "Railroads, Finance and Organization," Chapter I

[5] If this mortgage is accompanied by bonds in proper form to be sold to the public, the construction company may cause the bonds to be sold, and thus reimburse itself. Such an arrangement, instead of the one described in the text above, might be carried out where the company acquiring the property had no large first refunding mortgage. The practice is antiquated, for large first refunding mortgages as described above are now generally resorted

transferred to the trustee, *T*, named in the new first refunding mortgage (the large limited open-end mortgage mentioned in the previous section and designed to care for the company's financial needs for a number of years), and the trustee authenticates bonds equivalent to the purchase price of the property, which bonds are sold by a banker, *B*, to the public for cash, and in this way the construction company reimburses itself for the cost of the property.[6] The effect of this transaction is that the trustee holds the legal title to *M* conveyed through



Acquisition of Property Through Construction Company and Purchase Money Mortgage to Avoid the Effects of After-Acquired Clauses in Prior Mortgages

the purchase money mortgage and that company *ABC* never held anything but the equity of redemption. Therefore, the after-acquired clause of mortgage 4 operates as a lien on the

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to Bonds outstanding under the older arrangement are frequently called purchase money bonds. They have, as is indicated above, a first lien on the new property prior to the lien obtained under the old mortgages of the company by virtue of their respective after-acquired clauses Where the property acquired is of a special kind, the purchase money bonds may be named to describe the property on which they rest, as for example, extension bonds, improvement bonds, bridge bonds, and so forth

[6] If the mortgage provides, as it likely may, that bonds shall not be issued in excess of a certain percentage of the value of the property (see page 223), the remaining part of the purchase price paid in cash would come from earnings of *ABC* or from sale of stock.

equity of redemption only. In other words, mortgage 4 obtains only a second lien on property *M*, the first lien being appropriated by the above device to the new mortgage.

In summarizing the situation up to this point as far as the order of liens is concerned, we find:

Mortgage 1 has a first lien on property *A*.
Mortgage 2 has a first lien on property *B*.
Mortgage 3 has a first lien on property *C*.
Mortgage 4 has a second lien on properties *A*, *B*, *C*, and *M*.
The new mortgage has a first lien on property *M* and a third lien on all other properties.

The student should bear in mind that the plan explained above was used during the era of railroad construction and expansion, when the situation set forth in the imaginary example on page 229 frequently existed. It represents, however, the method by which certain large and important refunding bond issues, still outstanding, originated.

Effect of refunding.—But the new mortgage was made big enough not only to acquire property *M* and to provide for new financing, but to refund as well the old mortgages. Therefore, a notice will be published offering to exchange new bonds for bonds secured by mortgages 1, 2, 3, and 4. Whether holders of these bonds should make the exchange, assuming, of course, that their bonds have not yet matured, is a question that we shall discuss later. We may suppose now that one-half of the bonds of each issue are voluntarily exchanged. The new mortgage would likely have a provision in it to the effect that as the old bonds are surrendered, they shall be turned over to the trustee in the new mortgage and by him held for the benefit of all bondholders protected by that mortgage.

We may inquire now about the status of the various bonds. The new bonds have an interest in the old mortgages, since their trustee holds bonds secured by those mortgages.[7] The situation may be summarized thus:

Bondholders 1 (those who hold bonds secured by mortgage 1 and who have not made the exchange) have a one-half interest in the first lien on property *A*
Bondholders 2 have a one-half interest in the first lien on property *B*

[7] Under a doctrine of equity the same rights would probably arise simply by virtue of the exchange, even if the exchanged bonds, instead of being held by the trustee, were canceled by the company The usual practice, however, is to give the custody of such bonds to the trustee.

Bondholders 3 have a one-half interest in the first lien on property *C*

Bondholders 4 have a one-half interest in the second lien on properties *A*, *B*, *C*, and *M*

The holders of the new bonds, whether their ownership came through purchase or through exchange for old bonds (for all must be treated alike), have a one-half interest in the first and the second liens on properties *A*, *B*, and *C*, also a third lien on such properties, besides a first lien on property *M*

We may now see just what the effect of the division of the liens would be. In order to present the situation clearly, we may assume that the company fails and that under a decree of equity the properties are sold separately in order to determine what they are worth. Let us assume that they sell for the following amounts:

A—$2,000,000; *B*—$1,000,000; *C*—$2,000,000; and *M*—$5,000,000.

The first lien on property *A* is for $1,000,000, of which bondholders under mortgage 1 hold one-half interest and bondholders under the new mortgage hold the other half. Since the property sold for more than the first lien, the first lien will be satisfied and the remainder will go to the holders of the second lien The second lien amounts to $6,000,000, of which the bondholders under mortgage 4 hold a one-half interest, the other half belonging to bondholders under the new mortgage.

Therefore, the $2,000,000 proceeds from property *A* will be divided as follows

Of the first lien of $1,000,000, bondholders 1 will get $500,000 and bondholders under the new issue will get the other $500,000. The remaining $1,000,000 of the proceeds will be divided between bondholders 4 and the new bondholders, one-half to each group, since each has a half interest in the second lien on this property. It will be seen that bondholders 1 who "stood pat" will be paid their bonds in full, and that out of this property the new bondholders will get $1,000,000, one-half of which came through ownership of a half interest in the first lien and the rest through half ownership in the second lien on property *A*.

The entire first lien on property *B* amounts to $2,000,000, held jointly in equal shares by bondholders 2 and the new bondholders. Since the property sold for only $1,000,000, the first lien cannot be satisfied in full and the second lien will be worthless. From this property, then, the bondholders who retained bonds 2 will get $500,000, or 50 cents on the dollar.

of their \$1,000,000 holdings, and the bondholders under the new mortgage will get the other \$500,000.

As to property *C*, the same reasoning may be applied. The full first lien is \$3,000,000, held in equal shares jointly by bondholders 3 and the bondholders under the new mortgage The property sold for less than the amount of the first lien, and therefore the second lien will be worthless and the proceeds will be divided \$1,000,000 to bondholders 3 and \$1,000,000 to the bondholders under the new mortgage.

Property *M* is sold for \$5,000,000 and all of this as far as necessary will go to satisfy the first lien. The first lien is the new mortgage, the full amount of which may be summarized as follows for cash, \$5,000,000, for exchange for old bonds: bonds 1, \$500,000, bonds 2, \$1,000,000; bonds 3, \$1,500,000, bonds 4, \$3,000,000; total, \$11,000,000. To satisfy these bonds, we have thus far accounted for \$1,000,000 from property *A*, \$500,000 from property *B*, and \$1,000,000 from property *C*, making a total of \$2,500,000, leaving \$8,500,000 to be satisfied, if possible, from property *M*. But since property *M* sold for only \$5,000,000, the proceeds will go to the bondholders under the new mortgage who have the first lien, and the second lien, belonging to bondholders under mortgage 4, will be worthless.

The situation may be summarized as follows:

	Amount outstanding	*From A*	*From B*	*From C*	*From M*	*Total*	*Per cent*
Bdhldrs 1	\$500,000	\$500,000				\$500,000	100
Bdhldrs 2	1,000,000		\$500,000			500,000	50
Bdhldrs 3	1,500,000			\$1,000,000		1,000,000	$66\frac{2}{3}$
Bdhldrs 4	3,000,000	500,000				500,000	$16\frac{2}{3}$
New Bonds	11,000,000	1,000,000	500,000	1,000,000	\$5,000,000	7,500,000	$68\frac{2}{11}$

From the foregoing summary it appears that all the holders of the old issues, except those who retained bonds 1, were better off under the protection of the new mortgage than under the protection of their old liens. This, then, is the first inducement that might be held out to the old bondholders—a purely monetary advantage. If more property had been acquired, which probably would have been the case if the company had remained in existence, it is likely that the new bonds would have fared relatively still better, considering, as we must, that the old properties would have become antiquated and of less value.[8]

[8] Other inducements that may be offered are discussed in the chapter on refunding, page 264.

Callable bonds.—In modern issues of bonds no room is left for doubt as to whether a piece of financing, such as that described, will be successful. The bonds issued under modern mortgages run generally from thirty to fifty years, but a clause is usually inserted, as we shall see, which provides that, at reasonable times before final maturity and under carefully prescribed provisions, the bonds may be called, usually at a premium. If such a provision had been included in the older issues of our hypothetical case, the situation would have been handled somewhat as follows: The *ABC* company would have arranged with a banker to underwrite the refunding. Announcement would then have been made that the bonds under the new issue were being offered for those under the old issues, and a provision would have been inserted to the effect that those bondholders who did not care to take the new bonds would be paid in cash. As far as the bondholders were concerned, then, they would be required either to take the new bonds or to accept the cash. If the old bonds were not turned in, they would no longer draw interest, but cash would be held for their redemption. The bankers would have to stand ready to supply all the cash necessary to take up the bonds offered for redemption and would reimburse themselves by taking the bonds that had been provided for the refunding of the old issues. The bankers, then, might have to supply a considerable amount of cash; on the other hand, they might have to supply practically none. In our supposititious example,[9] they would have had to supply $6,000,000 ($500,000 for holders of bonds 1; $1,000,000 for 2; $1,500,000 for 3; and $3,000,000 for 4), or if the bonds were redeemable at say 105, the cash required would be $6,300,000. In any case, the arrangement between the company and the banker would likely provide a stipulated commission, which would be earned whether a little or a great deal of cash were needed. The banker might make an extra profit if the refunding bonds taken in place of the older bonds could be sold at a profit. On the other hand, to be sure, the banker might be out of pocket on the transaction, since he might be required to provide cash to take up most of the bonds and then find the refunding bonds salable only at a great discount.[10]

[9] See pages 229–234

[10] For a notice of a transaction somewhat similar to the one described, see C. W. Gerstenberg, "Materials of Corporation Finance," pages 320–321

Subsidiary as a method of avoiding after-acquired clause. In the preceding problem we saw how the purchase money mortgage principle was used to avoid placing newly-acquired property under the lien of the after-acquired clause in a corporate mortgage. We still have to explain how subsidiary companies, leases, and consolidations are used for the same purpose. Let us suppose that company *A* has a mortgage of $5,000,000 on its property, in which mortgage is found an after-acquired clause, and that *A* wishes to acquire property *M* with the proceeds of bonds secured by *M*. Company *A* may organize a subsidiary, *S*, to take over *M* and to issue bonds for this purpose. In this case the stock of *S* would have to be deposited with the trustee in the mortgage under the terms of the after-acquired clause contained in that mortgage. But *S* could acquire property *M* through the sale of stock to the public or it could issue bonds which would have a first lien on *M* since they would be the first bonds issued by the corporation owning the property. The after-acquired clause of company *A* would have no effect since the property really never was acquired by *A*.

Financing subsidiaries.—But where a subsidiary needs money and raises it on its own initiative and in its own name, several difficulties may arise. If stock is sold, unless the parent company is prepared to take its proportionate share of the new issue, control of the subsidiary is likely to be impaired Thus, if company *A* controls company *S* by a 51 per cent holding of the latter's stock, any considerable amount of new stock going to outsiders is likely to reduce the 51 per cent to something below 50 per cent of the total stock outstanding. Again, if bonds are to be sold by *S*, the holders of these bonds will have a claim on the property of *S* prior to that of the stockholders, and to that extent the value of *A*'s holdings will be impaired. The solution of these two difficulties, it would seem, is to put *A* in a position where it can provide the funds to buy *S*'s stock or bonds whenever they are offered. Not only would such a procedure avoid difficulties, but it would, as we shall see, offer positive advantages.

Large refunding issues, such as those we described as being used to meet the difficulties presented by piecemeal financing, provide an expedient method of financing subsidiaries to meet the difficulties outlined in the previous paragraph. The

process is very nearly the same as that followed in the acquisition of new property by a parent company The method may be described as follows:

The property to be acquired is owned by a construction company. Title to the property is transferred from the construction company to *S*, the subsidiary, which gives a note and mortgage to Company *A*, the parent company, in consideration of the latter's delivering bonds of its first refunding issue to the construction company. The notes and mortgage are transferred by way of pledge to the trustee in *A*'s large refunding mortgage. The trustee authenticates bonds, which are turned over to the construction company to be sold to the public through a banker. Thus the transaction is financed through the issuance of the parent company's bonds that already have a market. The rate paid is perhaps much less than would be required by investors of a small issue by an unknown company, *S*, and the result of the whole scheme has been to strengthen the parent's control over its subsidiary, for the parent company is now a creditor as well as a stockholder.

The practice described above was followed in the period when expansion took place by the acquisition of properties from other companies, and when sudden increases in demand for a company's product or services necessitated immediate plant expansion Nowadays expansion is largely a continuous process, financed by the sale of the subsidiary's securities, or by the issuance of securities under the parent company's open-end mortgage. The parent company's equity in the subsidiary company is so large, as compared with any underlying indebtedness that may be secured by mortgages having after-acquired clauses, that the parent company does not worry about the prior claim of such underlying issues. It goes on increasing its equity in the subsidiaries and paying off the underlying indebtedness. In this way prior claims are eliminated. For further information as to current financing of subsidiaries, see page 701.

Guaranteeing bonds of subsidiary.—It may be expedient to permit a subsidiary to pay for its newly acquired property with the proceeds of its own bonds Since the issue is likely to be small and the subsidiary little known, these bonds will lack the essential investment element of marketability and

will therefore have to yield a high rate of interest. If, now, the subsidiary has to pay dearly for its capital, the parent company will suffer, since little will be left from the earnings with which to pay dividends on the subsidiary's stock held by the parent company. To meet this difficulty the parent company may guarantee the interest on the bonds of the subsidiary. Popularly speaking, such bonds will be known in investment circles by the name of the guaranteeing company Since they become well-known and have the credit of the parent company as well as that of the subsidiary to add to the security of the property itself, the bonds will find greater favor among investors and will sell at a higher price, or what amounts to the same, with a lower rate of interest. Often, principal and interest are guaranteed. That this guarantee really means something was shown by the $38,000,000 judgment rendered against the Denver & Rio Grande R. R. in favor of the bondholders of the Western Pacific, whose bonds the former had guaranteed.

It should be noted here that the contract of guarantee is frequently stamped on the face or reverse side of the bond, in which case the bond will be called stamped[11] or indorsed. If no statement of guarantee is on the bonds, they will likely be called assumed bonds, though the legal effect of assumption of liability is practically the same as that of guarantee.

Collateral trust bonds.—This is an appropriate place to discuss collateral trust bonds, since they are frequently used either to acquire subsidiaries or to do some financing when subsidiaries' securities are unpledged under other mortgages.

Let us suppose that company *A* wishes to acquire company *S*. How may *A* do it with little expenditure of its own funds? *A* may simply borrow enough money from a bank to pay for a controlling interest in the stock of *S*, then deposit this stock as collateral to secure an issue of collateral trust bonds, and with the proceeds of these bonds repay the loan. Since it is customary that all loans shall be secured by collateral whose value is in excess of the loan, part of the money required would, in this instance, probably come from the surplus earnings of *A*.

These collateral trust bonds are as good as the security that is behind them, though, to be sure, they have also the

[11] Sometimes the term "stamped" is used to indicate that the bonds have had government revenue stamps of some country attached to them.

general credit of *A* behind them. In many cases the addition of this general credit—that is, the obligation to pay the bonds no matter what happens to the security—is regarded as reducing the risk somewhat and the bonds will therefore command a good price, though they may pay but a fairly low rate of interest. To be sure, the income from the collateral ought to be greater than the amount needed to pay the interest on the bonds, for the difference is the gain to the company issuing the collateral bonds and represents the return that company gets for assuming the risk of issuance.

Collateral trust agreements under which collateral trust bonds or notes are issued are usually complicated instruments. If the trust issue is of the open-end type, the indenture must carefully define the terms under which additional bonds may be issued and must indicate how much collateral must be deposited and how it is to be valued. In either the closed-end or open-end type, considerable attention must be given to the terms under which substitutions[12] may be made for pledged securities, and to the maintenance of the value of the collateral. The instrument carefully goes into the subject of voting of pledged securities and the rights to interest and dividends received from pledged securities. It makes provision for the protection of the value of the pledged securities in case of certain changes in the financial structure of the companies whose shares are pledged. The provisions of the collateral trust agreement must conform with the requirements of the Trust Indenture Act of 1939, if the securities to be issued thereunder are subject to the Act.[13]

The holding company equivalent to collateral trust bond method of financing.—Sometimes use is made of the holding company plan of acquiring property. The practical difference between the holding company method and the collateral trust bond plan is that where collateral trust bonds are used, a trustee holds the title to the collateral as security for the bonds sold to the general public. Where a holding company is used, it, instead of the trustee, holds the collateral. Another difference is that the holding company is likely to sell stock instead of bonds.

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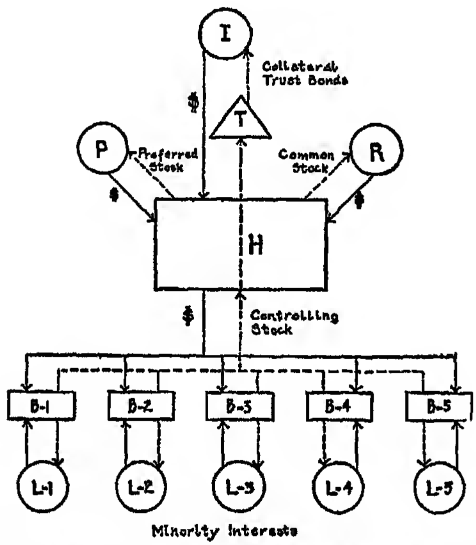
[12] The famous Kreuger & Toll failure taught not only investors but bankers as well that permitting a substitution of securities par for par was a grave mistake

[13] See page 207

The plan, which has frequently been used to promote so-called chain enterprises, is illustrated in the diagram on this page, based upon a chain of banks.[14] *R*, the promoter, takes the voting common stock of the holding company, *H*, and acquires funds by the sale of non-voting stock to the public, *P*. *H* invests this money in a controlling interest of bank number *B*-1, the minority interest in which is sold to local business men, *L*-1. The stock of *B*-1 is deposited with a



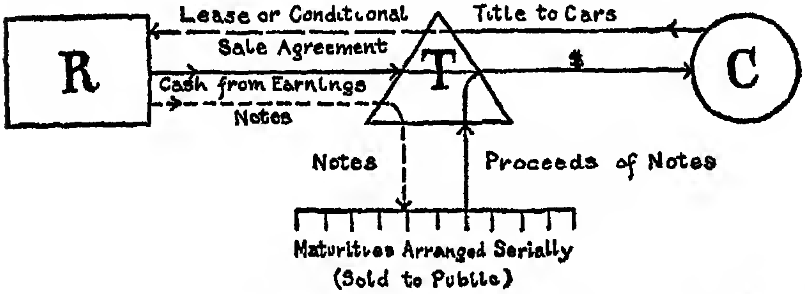
Financing Chain of Banks Through Collateral Trust Bonds and Preferred Stock of Holding Company

trustee as security for collateral trust bonds sold to the investing public, *I*. The proceeds of these bonds are used to buy a controlling interest in the next bank, and so on. Instead of using the collateral trust bonds, funds for the successive purchases of controlling interests may be obtained from new issues of preferred stock. The better plan is to use a com-

[14] This system of promoting, at least as far as banks are concerned, has been under attack for some time Starting with the general clamor for reform of bank control in 1933, legislation has been introduced in Congress intended to prohibit the common ownership of stock of several banks and to limit the proportion of a bank's stock which may be owned by one corporation The effectiveness of the plan of financing described has already been hampered by the provisions of the Clayton Act making illegal certain types of interlocking bank directorates

bination of stock and bonds. The bonds will bear lower income charges, but the stock will supply an equity in the holding company above the amount of the bond issue Some years ago a chain of banks was promoted in this way, the promoter being made president of each one of the local banks at a salary of only $500. His total salary, however, was $55,000, since there were one hundred and ten banks in the chain

Avoiding the after-acquired clause by a lease.—In connection with the acquisition of equipment by railroad companies, leases, under what is called the "Philadelphia plan," are used to avoid the effects of after-acquired clauses Where a road like the Erie or New York Central, each with many



Acquisition of Rolling Stock Through Issuance of Equipment Trust Notes

bond issues secured by mortgages containing after-acquired clauses, needs a thousand cars or a hundred locomotives costing several million dollars, and wishes to pledge the equipment as security for notes used to pay for the equipment, the rate of interest on those notes would be very high indeed if the security they presented were a lien subordinate to that given to four or five other mortgages through their after-acquired clauses. The method of using the lease to overcome this objection may be illustrated by means of the diagram above.

We may assume that railroad *R* wishes to buy three thousand cars from car company *C*, the total consideration to be $3,480,700.[15]

The chain of considerations begins at the point where the title to the cars is transferred from the car company to a

[15] These facts are assumed from the conditional sale agreement, C. W Gerstenberg, "Materials of Corporation Finance," page 299 See also, *ibid*, page 313.

trustee, T.[16] The trustee delivers possession of the cars to the railroad under a lease, the consideration for which is the payment of a certain sum of money, say $440,700 in cash, to give an immediate equity in the property, and the issuance for the remainder of the purchase price of equipment trust notes, which will be secured by the equipment and the lease thereon. These equipment trust notes will be sold to the public and the cash delivered to the car company.

On account of local statutes, instead of the car company passing title to the trustee and the trustee giving a lease to the railroad, the same plan is practically worked out by a conditional sale agreement. The effect in each case is that the actual title of ownership remains with the trustee, T, until all the notes delivered by the railroad company are paid.[17] Prior to the war, the general practice was to issue the notes to the amount of 90 per cent of the cost of the equipment and to retire them serially in ten years. The present practice is to issue them for only about 75 per cent of the cost and to retire them serially in ten or fifteen years.

In the case presented the period is ten years and since there were 3,040 thousand-dollar notes, 304 would fall due each year, or 152 each half year. When the 3,040 notes are all paid off, the railroad company will pay a nominal consideration, say ten dollars, and the trustee will deliver complete title to the railroad company.

Oil companies, tank car companies, and tank line companies, as well as other enterprises having large amounts of capital invested in movable and salable equipment, have made extensive use of the Philadelphia plan of equipment trust obligations. The equipment trust plan was applied for the first time in 1939 to the financing of the purchase of transportation flying equipment. The equipment trust notes in this instance mature over a period of five years. The plan is the same as that described for railroads. Title to equipment remains with the trustee and is leased to the company in need of the equipment. The lessee undertakes to pay

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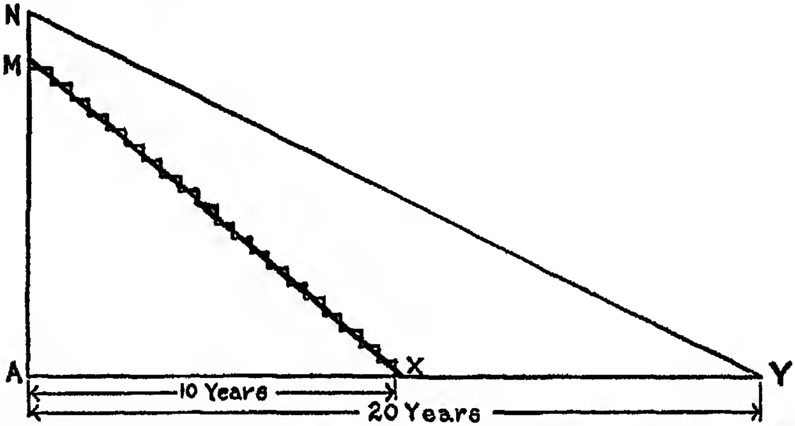
[16] The equipment trust agreement will probably provide that a metal plate must be fastened securely to the car with a statement thereon that the car belongs to the trust company, the railroad's interest may be indicated by some word, such as "Erie," painted on the side of the car.

[17] For an example of a conditional sale agreement, see C. W. Gerstenberg, "Materials of Corporation Finance," page 299.

sufficient rental to pay interest on the notes and the principal of each series at maturity.

How equipment trusts satisfy all parties.—In the above described transaction four parties are involved, the car company, the trustee, the railroad, and the public. The car company gets what it desires, cash upon delivery of the cars, the railroad attains its object, the use or possession of the cars and ultimately the title thereto, and the public gets what it wants, a first lien on the equipment, for the railroad company does not acquire title to the cars until the public has been removed from the situation by the redemption of the equipment trust notes.



Increase in Equity Behind Serial Equipment Trust Notes as Issue Approaches Total Redemption

Why equipment trust notes are good investments.—The diagram on this page will indicate why equipment trust notes are usually considered good investments. On the horizontal axis, AX measures the ten years during which the notes will remain outstanding, and AY measures the life of the equipment.[18] On the vertical axis, AN represents the original value of the equipment (in this case $3,480,700), AM represents the original amount of notes outstanding (3,040,000), and the distance MN represents the original equity behind the notes. The line MX is a smoothed curve representing the decrease

[18] These periods are likely, in ordinary cases, to be ten years and twenty years, respectively The mortgage securing the notes provides that if any of the equipment is damaged, it must be immediately repaired, and if destroyed, must be replaced by other and similar equipment or the money equivalent thereof placed in a fund securing the outstanding equipment notes

in the amount of notes outstanding, and the line NY represents the depreciating value of the equipment, which is in this case supposed to be reduced not to junk value, but to nothing when Y is reached. It will be noticed that not only does the space between NY and MX increase absolutely, but that it increases very rapidly relatively to the notes outstanding as the number of notes outstanding decreases

Should the railroad company default in the payment of interest or in the payment of the sum necessary to redeem a semiannual installment of principal, the trustee will simply declare the lease void and will make a new lease to some other railroad.

On account of the economic and legal position of the holders of these equipment trust notes, defaults are almost entirely unknown. If a railroad fails and a receiver is appointed, he will usually apply to an equity court for authority to continue making the payments on these equipment trust obligations as they mature.

Avoiding after-acquired clauses by consolidation.—We have seen in the preceding discussion that the after-acquired clause may be avoided by using a purchase money mortgage, by permitting a subsidiary to acquire the property, or by taking only the possession instead of the title to the property. After-acquired clauses are sometimes entirely nullified by a consolidation of the issuing company. Thus, if corporation A issues a mortgage with an after-acquired clause and then A consolidates with B, as far as that after-acquired clause is concerned A is no longer in existence—its existence has been lost by the merger—and it therefore cannot acquire property to which the lien of its mortgage can attach. Sometimes a clause is inserted in the mortgage to guard against this, but to discuss such a clause would lead us into legal intricacies beyond the purview of this book.[19]

Stabilized bonds.—A new type of bond, known as the stabilized bond, made its appearance in 1925. It is discussed here for its interest rather than its importance. The purchasing power of money is not stable; it varies with the rise and fall in commodity prices. Thus, if a bond were purchased at a period of low prices and matured when prices were high, the bondholder would not get back the full value

[19] See A Machen, "Modern Law of Corporations," Section 1866

of what he had loaned the corporation. Similarly, the fixed interest payments are subject to changes in value.

In order to eliminate the risk arising from fluctuations in the purchasing power of the dollar, the stabilized bond has been devised. Its first important use was in 1925 in an issue of the Rand Kardex Company.[20] The corporation issuing the bond agreed to pay at maturity of the bond the sum of money possessing the purchasing power of $1,000 at the time the bond was issued, and interest at the rate of 7 per cent per annum, payable quarterly, in such sums as would, when the payments were due, equal in purchasing power 1.75 per cent of the purchasing power of $1,000 in 1925 The payments were to be based upon the index number of prices of commodities maintained by the United States Bureau of Labor Statistics. The agreement under which the bonds were issued provided that in case the index number at any due date were found to be more or less than that fixed for July 1, 1925, by as much as one-tenth of the index number of July 1, 1925, then for every full one-tenth rise or fall, there should be added or subtracted, respectively, one-tenth of the amount due A rise of one-tenth at an interest payment date would mean the payment of $1 75 more of interest (the standard quarterly payment on the 7 per cent $1,000 bond being $17.50), and a fall at the same rate would mean a payment of $1 75 less. If at maturity the index number were found to have increased two-tenths of the index number of July 1, 1925, showing the purchasing power of the dollar to have fallen, the bondholder at maturity would get back $1,200.

This form of bond is not likely to become popular with either corporations or investors. The corporation cannot tell when it issues such bonds what its liability will be at maturity [21] The investor is likely to consider as a loss any deduction because of a decline in the purchasing power of the dollar, even though he sees the justice of the arrangement, he cannot overcome easily the feeling that "a dollar is a dollar."

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[20] The bonds were retired shortly after issuance, upon merger of the corporation with the Library Bureau.

[21] Professor Irving Fisher, in his explanation of stabilized bonds in the Nov 13, 1925, issue of the *Annalist*, says "The argument merely shows how ingrained is the money illusion, the superstition that 'a dollar is a dollar,' that when we know how many dollars we owe, we know how much we owe, and that when we have to pay a larger number of dollars our debt is thereby increased "

CHAPTER XIV

EXTINCTION OF BONDED INDEBTEDNESS—CONVERSION

Methods of extinguishing bonded indebtedness.—Since bonds are debts, and since all debts must be liquidated sooner or later,[1] it behooves us to study what plans a company can and does make for wiping out the obligation of a bond issue. Three methods are available—conversion, refunding, and redemption. Any of these methods may, if the contract so provides, take place at or before maturity. Of course the parties may, subsequent to the issue of the securities, that is, after the contract is first entered into, change the contract by mutual consent, and we find therefore that some of these processes take place before maturity—not in pursuance of the original contract, but as the result of subsequent negotiations.

By conversion we mean the exchange of the bonds for certain other forms of security, usually stock

By refunding we mean the exchange of the bonds for other bonds whose maturity is deferred to a date later than that of the original issue.

By redemption we mean the exchange of bonds for cash.

Why conversion privilege is given.—Usually the conversion is at the option of the bondholder.[2] The conversion privilege adds a speculative interest to bonds and is given to

[1] The statement in the text is not accurate, at least as far as practice is concerned, for some companies—the Public Service Company of New Jersey, for example—do issue bonds that by their terms are perpetual These securities, it would seem, are hybrids, having some of the characteristics of bonds and at least one of the characteristics of stock, that is, perpetual obligation In other cases it is intended that the bonds will not be paid off, but will be refunded The principles underlying this proposition have been described (pages 193 *et seq*), and will be further considered in the next chapter.

[2] At one time the Consolidated Coal Company had bonds outstanding in which the option belonged to the company. The 5½ per cent convertible investment certificates of the Associated Gas & Electric Company were convertible at the holder's option, but after 1933, at the option of the holder or the company

make them more attractive. The company issuing them, especially if a railroad, has usually exhausted the earlier liens on its properties and gives the conversion privilege as a substitute for a good lien. Thus, most railroad convertibles are secured by junior mortgages. The convertibles of industrial companies may be either debentures or first mortgage bonds. Industrial companies commonly do not issue bonds for long terms. Indeed, a convertible bond of an industrial company may be regarded as a temporary security, the final security being the stock into which the bond is to be converted. Frequently, an issue of common stock is authorized at the time when the convertible securities are authorized, in order to assure a sufficient amount of unissued stock to take care of the conversion. In many instances the intention in financing through the sale of convertible securities is the ultimate issuance of stock, not at the outset, but through the sale of convertible bonds. Since the conversion privilege takes the place of good security, convertible bonds are often more popular than stock and are easier to sell.

In 1929 convertible bonds were a prominent feature of the year's new capital issues, and in 1930 their prominence was largely maintained. The principal reason for the popularity of convertible bonds during 1929 was the demand of investors for a security that afforded safety combined with a possibility of profit through conversion into common stock. Common stocks, during 1925–1929, had risen tremendously in value and were gaining in popularity. In other words, bond issues had been savored with the convertible feature to meet the public taste.

Why convertible bonds are popular.—Let us examine somewhat more closely the reasons for the popularity of convertible bonds.

When an investor buys a bond convertible into stock, he gets (1) the certainty of income characteristic of the bond; (2) the preferred position of a creditor if the company should fail; and (3) the chance of sharing in the profits if the company becomes prosperous, which chance is the peculiar privilege of the stockholder. Frequently, we find convertible bonds selling at one time on a basis which reflects the investment position of the bond—considering security and income—and later selling at a much higher price, simply because they tend to follow, on the market, the stock into which they are

convertible. This upward movement will always take place when the company enters a period of prosperity and is able to pay high dividends. If the company reduces its dividends, the stock and bonds will recede in price, the stock to a price low enough to conform to the reduced dividend rate, but the bonds to a level established by the investment position of the issue without regard to the conversion privilege.[3] An example is the Great Northern Ry. Co. Series "G," 4% bonds, issued in 1936 and due 1946. Each $1,000 bond is convertible into 25 shares of preferred stock. The following table tells the story

	Preferred Stock			*Bonds*	
Year	*High*	*Low*	*Dividends*	*High*	*Low*
1936	46⅜	32¼	Nil	124¼	109⅛
1937	56¾	20½	$2	141⅞	98⅛
1938	30⅝	12⅜	Nil	103⅝	74

Use of convertible bonds to cover short sales of stock.—Convertible bonds have a peculiar interest for stock market

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[3] The table below shows how the price of bonds issued by the Anaconda Copper Mining Co was affected by increased dividends on its common stock, into which the 7 per cent debentures of 1938 were convertible From February, 1925, to May, 1928, the company paid 75 cents quarterly on its common stock, in August and November, 1928, $1, in February, 1929, $1 50, and in May, 1929, $1 75 The bonds were convertible into common stock at any time prior to February, 1933, at the following rates the first $10,000,000 of these debentures at $53 per common share, the next $10,000,000 at $56, the next $10,000,000 at $59, the next $10,000,000 at $62, and the last $10,000,000 at $65 The bonds were retired at 110 on August 1, 1929

	Common Stock		*Bonds*	
Year	*High*	*Low*	*High*	*Low*
1924	48¼	28½	103⅜	94¼
1925	53¼	35¼	105⅞	100
1926	54½	41½	109½	102½
1927	60½	41¼	116½	106¼
1928	120¼	53¾	191	110½
1929	174⅞	100	268	160

We find spectacular illustrations of convertible securities that increased enormously in value during the stock market rise of 1925–1929 because of their convertible feature In many cases the issues have disappeared, either through conversion or through redemption For example, the Standard Gas & Electric Convertible 6's due 1933, convertible into common stock at $37 50 a share, were offered at 97, in other words, the conversion rate was 26⅔ shares for each $1,000 bond The prevailing price of the common stock at the time of the issuance was $25 a share In 1925 the common sold at $60, thus giving the debenture a market value of $1,600 at that time These bonds were called for redemption at 105 Bondholders had the option of exercising the conversion privilege before redemption took effect. Those who converted their debentures into common stock and continued to hold it, saw their $970 investment in a convertible bond attain a value of close to $6,500 when in 1929 the stock reached its peak at $243¾ a share In 1938, the low price for the common stock was $2 a share. In that year the company was reorganized under the bankruptcy laws.

speculators. They may be used to cover short sales of stock.[3a] The process will be described very briefly

Suppose we wanted to sell short 100 shares of company *A* stock, that is, we wanted our broker to sell at a certain price, borrow the stock to fill the contract, and then buy it later on our order (covering) to pay back the loan. Of course we would enter upon this transaction with the expectation that the price of the stock was going to fall and that we would make our profit by buying at a price lower than the price at which we sold. If, however, the price should go up, we would sustain a loss, and since theoretically there is no limit to the upward trend, our loss might be very great. To illustrate: if we got the stock at 80 and it declined to 60 when we "covered," we would make, less various expenses,[4] $20 a share, or $2,000. If, however, it went up to 100, we would lose $2,000.

Suppose, now, company *A* had an issue of bonds convertible into the stock just described, paying 6 per cent and selling at 80. We would order our broker to buy an equivalent amount of bonds at the same time that he sold the stock. If the stock went down to 60, we would gain $20 a share, but we would not lose an equivalent amount on the bonds, because the bonds selling at 80 and paying 6 per cent would, if the maturity was very far distant, yield 7½ per cent, a sufficiently high yield to warrant the maintenance of the price on the market at 80. In practice, the bond might drop a point or two, that is, say, to 78. Leaving out commissions, taxes, interest, and possible adjustments for dividends as well as interest, the result of the transaction would be a gain of $2,000 on the stock and a loss of $200 on the bonds. If, however, the stock went up to 100, instead of covering our short sale by purchasing stock we would convert our bond and thus repay the loan of the stock; our only loss then would be the incidental expenses. The possible use of convertible bonds in this way

[3a] Directors and officers of corporations whose securities are registered on a national securities exchange, and stockholders who beneficially own more than 10 per cent of any class of registered security, are prohibited, under the Securities Exchange Act of 1934, from making short sales of the securities of the corporation in which they so qualify Other restrictions against short selling are contained in the regulations under the Act, such as the price at which short sales may be made.

[4] For an explanation of the mechanics of short selling, see C W. Gerstenberg, "Materials of Corporation Finance," pages 423–428 See also "Stock Exchange Practices," Report No 1455, 73d Congress, 2d Session, for another explanation of the mechanics of short selling

makes them very attractive to certain kinds of security purchasers.

Convertible bonds as a means of retaining control.—Professor Ripley in his "Railroads, Finance and Organization" suggests that the convertible bond might be used to retain control We may make the suggestion clear by again using imaginary figures. Suppose *X* controls company *A* and owns 50,000 shares out of 150,000 issued shares (authorized 250,000), the remaining 100,000 being scattered. *Y* surreptitiously buys 76,000 shares. *Y* will have control, for if the company has more shares, it cannot sell them exclusively to *X*, though *X* controls the board of directors, but will have to offer them to all stockholders in proportion to their stockholdings.[5] Thus *Y*, having got more than 50 per cent of the stock, will keep that advantage. If, however, the company had some convertible bonds, the directors, not being required by law to offer them to old security holders, could sell, let us say, $2,700,000 of the bonds to *X*, who could use them to bring up his stockholdings to 77,000 shares. It ought to be pointed out, however, that *Y* could probably enjoin this issue and conversion, since bonds are to be sold for the advantage of the company only and not to satisfy the needs of directors or stockholders. The days of Daniel Drew are over![6]

Convertible bonds reduce fixed charges.—Another advantage of convertible bonds is that their conversion reduces fixed charges. In practice this advantage may be more apparent than real. For example, the bonds may be convertible into preferred stock on which the dividends are a contingent liability. Moreover, as the conversion privilege becomes more valuable to the bondholder because the stock is beginning to yield large dividends, the bonds are relatively less troublesome to the company. In other words, to get rid of the fixed charges the company will have to offer higher rates in the form of dividends. If we recall principles already discussed—trading on the equity, and the relation of financial risk to stability of income—we see that the advantage of gradual reduction of fixed charges is not always an unalloyed blessing.[7]

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[5] See Chapter XX.

[6] If this aspect of the situation had been called to Professor Ripley's attention, he would probably have been the first to concede the justice of the author's contention. See Bouck White, "The Book of Daniel Drew"

[7] Out of a total issue of $49,711,000 of the Atchison, Topeka & Santa Fé Ry Co 4's of 1955, Series "A," $42,926,000 was converted into stock In years

Moreover, the mortgage or indenture may provide that the bonds need not be canceled after conversion, but may be reissued. Thus, the mortgage securing the General Consolidated Mortgage 4's and $4\frac{1}{2}$'s of 2003 of the Lehigh Valley R. R. Co. provides that the directors may under that mortgage issue convertible bonds and that any of such bonds converted into stock may be reissued. The Erie 4's of 1953 provide that converted bonds may be issued at such prices as from time to time shall be fixed by the board of directors, but at not less than the market value of the common stock on February 11, 1903, the date when the stockholders assented to the issuance of the bonds.

Some conversion contracts.—The conversion price is stated in terms of an exchange of one bond for shares at a certain price, or of one bond for a certain number of shares of stock. At one time the most usual conversion contract was par for par; that is, the privilege was given of exchanging a $1,000 bond for ten shares of stock with a par value of $100 [8] Sometimes, however, the stock was to be taken at either more or less than par. With the increase in the use of non-par stock, it became customary to permit the conversion into preferred or common shares at a certain price per share.

If the stock into which the security is convertible has par value, the law requires that the conversion privilege must be at a rate which will be equivalent to the payment of the par value of the shares which are to be received upon conversion. If the stock is without par value, the conversion rate must have a fair relation to the actual values at the time of the creation of the conversion privilege. Legal difficulties aside, it would seem fair to make bonds convertible into stock at the price at which the stock is selling at the time the bonds are issued, whether it be stock with or without par value. It is interesting to note in this connection that the 6's of 1926 of the American Smelters Securities Company provided that the bonds were not convertible unless at the time offered they had a New York market value of not less than par.

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when the company was paying 10 per cent on its stock, the conversion was costing the company 6 per cent on $42,926,000, or about $2,575,560 a year—a sum, if set aside annually, more than sufficient to retire the bonds at maturity

[8] For the wording of the usual agreement, see C W Gerstenberg, "Materials of Corporation Finance," pages 322–323. For a somewhat peculiar arrangement, see *ibid*, pages 105–6

Arrangements for conversion vary considerably. A few may be mentioned very briefly [9]

Baltimore & Ohio R R. Co. convertible 4½'s due 1960 are convertible into common stock from February 1, 1931, to January 31, 1936, at $120 per share; from February 1, 1936, to January 31, 1941, at $125 a share, and from February 1, 1941, to January 31, 1946, at $130 a share, with an adjustment in each case of accrued interest and current dividends. Thus, for $1,300 face amount of bonds the company would give, during the period when the $130 rate applies, only $1,000 in stock. If, then, stock were selling at 104, the bonds would be at the conversion point at ten-thirteenths of 104, or 80. Thirteen bonds, each with a par value of $1,000, would then sell at $10,400 and would be convertible into 100 shares of stock of the same market value

Alleghany Corporation collateral trust convertible 5's, 1944, floated in January, 1929, are convertible up to February 1, 1944, into seven shares of 5½ per cent preferred stock (without warrants) and ten shares of common stock.

Philadelphia & Reading Coal & Iron Co. convertible debenture 6's, 1949, issued during March, 1929, are convertible from May 1, 1930, to March 1, 1939, into 40 shares of common stock of the Philadelphia & Reading Coal & Iron Corp., the parent company.

American I. G. Chemical Corp. guaranteed convertible debenture gold 5½'s, are convertible at any time prior to January 1, 1939, on the following terms: up to December 31, 1931, into common "A" shares at the rate of 17 shares per $1,000 debenture; during 1932, at the rate of 16 shares; in each subsequent year the number of shares decreases at the rate of one share a year until 1938, when the conversion rate is to be 10 shares per $1,000 debenture.

The convertible 4½ debentures of the American Telephone and Telegraph Company were convertible at the rate of $120 of bonds for $100 stock, or the holder of a $100 bond could convert the bond, with a $20 cash payment, into $100 of stock. Of a total authorized issue of $67,000,000, bonds amounting to $65,100,000 had been converted into stock when the conversion privilege expired on March 1, 1925.

[9] See C. W. Gerstenberg, "Materials of Corporation Finance," pages 324 *et seq.*

Portland Railway, Light and Power Company 5's of 1942 provide that they may be converted into capital stock of the company at a price equal to the amount paid in on such stock plus $10 premium per $100 share This differential in favor of the stockholders makes up for the security the bondholder has enjoyed while it was expedient to retain the bond in place of the stock.

Dilution of conversion privilege and protection against it.—In the explanation of convertible stock given in Chapter VIII, the manner in which the conversion privilege may be diluted, changed, or destroyed has been indicated. The information given on page 145 applies in all respects to convertible bonds as well as to convertible stock. Furthermore, the protective provisions generally made against changes in the conversion privilege, explained on page 146, are also found in trust deeds creating issues of convertible bonds. A few examples of the effect of protective provisions are given below.

The 10-year convertible gold debenture 4½'s of the American Telephone & Telegraph Company, due 1939, are convertible into stock from January 1, 1930, to December 31, 1937, provided that bonds called for redemption on any date within that period are surrendered for stock not later than the redemption date. The conversion prices at the time of the issue were as follows: during the year 1930, $180 a share; during 1931 and 1932, $190 per share, from 1933 to 1937 inclusive, $200 per share. Additional stock was issued to stockholders of record May 23, 1930, and as a result of an adjustment in the conversion price, this price during the remainder of 1930 was $166.88 per share, during 1931 and 1932, $175.46; from 1933 to 1937 inclusive, $183.74.

Under the indenture of the International Telephone & Telegraph Corp., dated January 1, 1929, relating to an issue of 10-year convertible 4½ per cent gold debenture bonds, the securities were originally convertible at the option of the holder into common stock at $200 per share from July 1, 1929, to July 1, 1932, inclusive; thereafter at $210 per share to July 1, 1935, inclusive; and after that date, at $220 per share. After giving effect to a split-up of the common stock in 1929 and to subscription rights in March, 1930, the debentures became convertible into common stock at the following prices: $64.1564 to July 1, 1932, inclusive, $66.9599 to July 1, 1935, inclusive; and $69.7634 to January 1, 1939, inclusive.

This indenture also makes provision that the holders of the convertible debentures shall, upon consolidation, merger, or sale of assets, be entitled to convert their bonds into the same kind and amount of securities and other assets as may be issuable or distributable under the terms of the consolidation, merger, or sale of assets, with respect to the number of shares of common stock into which the bond is convertible at the time of the merger or sale.

Other provisions of convertible issues.—Indentures securing convertible bonds contain many other peculiar provisions incidental to the privilege of conversion. The company will agree to reserve sufficient stock to carry out the conversion Interest and dividends will be adjusted when bonds are offered for conversion, the usual arrangement is to allow the bondholder the accrued interest on his bond, but to charge him the accrued dividends on the stock at the regular dividend rate The conversion may be limited in time both as to when it begins and when it ends.[10] Frequently, the bondholder is required to give a certain number of days' notice in writing before making the conversion. Sometimes the conversion can only be made on interest dates or on dates set by the directors.[11]

Conversion privilege offered subsequent to issue of bonds.—It may become expedient for a company to offer the conversion privilege after bonds have been issued; the usual intention in such an offer undoubtedly is to substitute the contingent charge of dividends for the fixed charge of interest.

The following provisions were made in 1918 by the Hocking Valley Products Co. The stockholders

> . . . voted to issue $1,000,000 6 per cent cumulative preferred stock, par $20, having same voting power as common stock, and with the provision that no mortgage or other lien prior to the preferred stock shall be created without the consent of 75 per cent of the preferred stock, such preferred stock to be redeemable all or in part after July 1, 1919, at 110
>
> The company offers to the holders of its first mortgage fifty-year 5 per cent sinking fund gold bonds, due 1961, the privilege of exchanging said bonds, with all coupons from and after January 1, 1919, and certificates for relinquished interest attached, for the 6 per cent preferred stock now authorized, upon a dollar-for-dollar basis, and at the time of such exchange the company will also deliver to the holders of said bonds so exchanged its ten-year 5 per cent certificates of indebtedness, dated July 1, 1918, in

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[10] See illustration on page 252

[11] The 6's of 1931 of The Texas Co were an example of this provision.

full payment of the certificates for relinquished interest held by them to the amount of such certificates accrued on July 1, 1918

The bonds, when acquired by the company, shall be held in trust for the security of the preferred stock until all of the outstanding bonds shall be acquired, at which time the bonds and mortgage will be retired and discharged [12]

Disadvantages of convertible bonds.—Since the conversion of bonds into stock is usually accompanied by an actual offer of the stock on the market, convertible bonds may be said to have the effect of injuring, though indeed very slightly, the investment position of the company's stock. Were this depression noticeable, the disadvantage would be serious, since it is always important that a company's stock sell well above par.

Another disadvantage of conversion may be apparent when it is considered what the purpose of a corporation is. Aside from the social benefits it renders in producing goods or services, it is managed for the profit of its owners, the stockholders. During the hard periods of corporate infancy, these people "hold the bag"—they get nothing but prospects. In the meantime the holders of convertible bonds are drawing their interest and are also possessors of the prospects of larger returns. When the corporate income increases, the bonds are converted, thus reducing the rate of return that can be paid on the original stock

Moreover, it should be noted that conversion injures the market position of bonds that remain unconverted. After a bond issue has been fairly well converted, the remaining bonds of the issue may become so limited that their marketability will be very low; few people will hold them and their value will become problematical. For example, when the conversion privilege on the Convertible 4's of 1955, Series "C," of the Atchison, Topeka and Santa Fé Railway Company expired on May 31, 1923, all but $526,000 of the $43,686,000 of bonds that had been issued had been converted.

Finally, the effect of conversion on the tax position of a corporation must be considered. When the bonds are issued, the Federal issuance tax of ten cents per hundred dollars of face value or fraction thereof is imposed.[13] At that time the

[12] Standard Statistics Service, from *Commercial and Financial Chronicle*, June 29, 1918.

[13] Internal Revenue Code, Sec 1801, as amended by the Revenue Act of 1939. On and after July 1, 1941, the rate of five cents, which prevailed prior to June 21, 1932, is reinstated.

corporation usually will not have in reserve sufficient stock for the conversion and will have to increase its stock for this purpose and pay the State tax thereon When the conversion is made, the Federal issuance tax of ten cents per hundred dollars will have to be paid [14] Moreover, when interest on the bonds is paid, the amount needed may be subtracted from the income before the net income is reported for Federal tax purposes. But when the bonds are converted, the dividends paid on the stock are taken out of the profits, on which the company must pay income tax Usually the State franchise tax is higher, too, where stock replaces bonds.

We may make the effect of taxes clearer by assuming a concrete case of a New York company issuing bonds to the extent of $10,000,000, and by calculating the additional tax burden involved if the company makes them convertible, increasing its stock to provide for the conversion, and if all the bonds are converted We may assume that the bonds are 6 per cent bonds and that the stock pays 7 per cent.

The company would have to pay $5,000 as a State tax on the increase of stock and $10,000 as a Federal issuance tax The Federal income tax on the $600,000 previously used to pay interest would be increased by 18 per cent (after 1939), or $108,000, and the State tax would likewise be increased by 6 per cent[14a] of $600,000, or $36,000. In other words, the conversion would cost an initial $15,000, and thereafter an annual charge of $144,000—a sum large enough to pay interest on 24 per cent of the bonds had they remained outstanding. To put it another way, if the bonds cost 6 per cent per year, the equivalent stock would cost over 7 per cent without yielding any added income to the owner.

Bonds issued with stock purchase warrants.—In an earlier paragraph we mentioned that the taste of investors for securities had turned, during the speculative fever of 1925–1929, from bonds to securities that offered a possibility of sharing in common stock profits. To meet market demands, and to make sure that an issue of bonds would sell, the plan was devised of coupling the bond with a warrant to purchase

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[14] See page 130, footnote 13 For description of taxes of this kind see Prentice-Hall Federal Tax Service, and Prentice-Hall State and Local Tax Service

[14a] After November 1, 1940, unless otherwise provided by statute, the New York State franchise tax will be 4½ per cent

stock at a certain price during a certain period. Stock issues, as well as bond issues with stock purchase warrants attached, appeared in great number, especially during 1929. The tendency to make bonds more attractive by according the purchaser rights to acquire common stock was followed to some degree in financing during the thirties.

The nature of stock purchase warrants is the same whether they are used in connection with an issue of stock or an issue of bonds. The explanation given on page 148 should therefore be consulted. Some illustrations of provisions included in stock purchase warrants issued in connection with bonds are given to supplement the material found on page 150.

The non-detachable warrants accompanying the Kansas Pipe Line & Gas Co. first 6's, Series A, due 1952, entitled the holder of each \$1,000 bond to purchase forty shares of common stock at the following prices \$6 per share to December 31, 1938, inclusive, \$8 per share thereafter to December 31, 1939, inclusive; and \$10 per share thereafter to December 31, 1940, inclusive. However, in case the debentures were called for redemption before December 31, 1940, the warrants were to become void at the close of business on the redemption day, unless exercised prior thereto.

The Southern Gas Utilities, Inc., first 6½ per cent Series "A" bonds of 1939 were issued with detachable warrants entitling the holders to purchase five non-par common shares at certain prices during certain periods, irrespective of the previous redemption of the bonds.

Chapter XV

EXTINCTION OF BONDED INDEBTEDNESS—REFUNDING

Purposes of refunding.—Refunding is much like conversion—a substitution of one kind of security for another. In refunding, however, the exchange is bond for bond. The purposes of refunding are to extend the obligation of a maturing issue in order to avoid a cash outlay, or to reduce the fixed charges of an issue that has still some time to run. If this latter purpose can be accomplished, it is quite likely that the company will wish to assure to itself for some time in the future the advantage of the new and lower interest rate, and the new refunding bonds will therefore run as long as the refunded bonds, or longer.

The two purposes above indicated are accomplished respectively (1) at or near the maturity of an old issue, and (2) at the time when investment market conditions are favorable. We may therefore say, in summary, that the two purposes are. (1) to meet maturing obligations, and (2) to take advantage of favorable market conditions before maturity.

Refunding in connection with raising cash.—Sometimes a third purpose prompts a company to undertake a process of refunding. Where a corporation wishes to raise additional cash through the sale of bonds secured by property on which other mortgages exist, it may refund the bonds secured by the underlying mortgages into the new bonds. This process has already been described.[1]

Refunding before maturity.—In refunding before maturity, the new issue may be simply for the purpose of reducing the interest rate on the old issue, or it may be for the purpose of carrying out some new financing.

How refunding before maturity is accomplished.—Refunding before maturity may be accomplished through negotiation, in which case the company must rely on the voluntary consent of the old bondholders; or it may, under modern mortgage

[1] See pages 228 *et seq*

agreements, be accomplished through the exercise of the company's option to redeem the old bonds. Thus, if the old bonds are redeemable at 105, the company simply calls the old bonds and offers cash or new bonds. The cash is obtained through a banker who reimburses himself by taking the refunding bonds offered the old bondholders.[1a] (See page 235.)

Refunding to reduce fixed charges.—The importance of taking advantage of improvements in a company's credit position or of a change in the money market may best be illustrated by the following imaginary example. Let us suppose that a company has sold $1,000,000 of its 6 per cent bonds at 80, and that the mortgage provides that the bonds may be called at 110 Let us assume further that the bonds have 75 years to run. When the market eases up and the company's credit position improves, it becomes evident that the company can sell 4 per cent bonds at 80, redeemable at 105. Would it pay to refund the old bonds? At first sight it would seem unprofitable, for while the company would receive only $800,000, it would assume an obligation of $1,375,000[2] But it is not pertinent to compare the company's obligation with what it received in cash on the first sale of bonds. Indeed, that latter fact is entirely irrelevant. The fact is that it has an obligation of $1,000,000. Would it pay to assume one of $1,375,000?

Suppose that the company provides for the amortization of the premium of $375,000 during the 75 years and that it carries out the amortization by redeeming an equal amount of bonds each year, that is, $5,000 at 105 Since the company is to reduce its bonded indebtedness each year, the average amount outstanding on which it would have to pay 4 per cent would be the sum of the amounts outstanding the first and last years, divided by 2; that is, $1,375,000 plus $1,005,000 divided by 2, or $1,190,000 Interest on this at 4 per cent would be $47,600. To redeem the $5,000 of bonds

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[1a] If the new bonds cannot be validly issued until the old bonds have been retired, and if the market is not suitable for the sale of a new issue at the time the redemption is to take place, the corporation may obtain funds for paying off the old bondholders by arranging a bank loan, with assurance as to renewal, to carry it until such time as a new issue can be favorably sold

[2] The company would need $1,100,000 in cash to redeem the old bonds at 110 To raise this sum with bonds sold at 80, it would have to issue bonds amounting to $1,100,000 divided by 0 80, or $1,375,000

at 105 each year would require \$5,250,[3] and the total annual burden of the issue therefore would be \$52,850. Since the interest on the old issue was \$60,000, the saving per year would be \$7,150, or for 75 years, without counting interest on the annual savings, it would amount to \$536,250. If the annual savings were set aside at 5 per cent compound interest, the total saving would be many times the amount of the original issue of \$1,000,000. The refunding would undoubtedly pay [4]

Many corporations took advantage of the period of low interest rates of the late twenties and thirties to reduce fixed charges through refunding operations. In 1928, for example, the Standard Oil Company of New York retired its debenture 6's due 1933, amounting to \$20,000,000, with funds obtained from the sale of \$20,000,000 of income 4½'s due 1931 to 1948. In 1939, the North American Co. sold \$70,000,000 of 3½, 3¾ and 4 per cent debentures and \$34,829,000 5¾ per cent preferred (\$50 par) stock, and applied the proceeds, together with treasury funds, to the redemption of all the \$42,565,000 5 per cent and 5½ per cent debentures and \$34,829,000 \$6 preferred stock of North American Edison Co. and \$23,913,000 of 5 per cent debentures of North American Co. held by the public The aggregate annual savings in interest charges and dividends as a result of the financing was \$850,000.

Refunding at maturity.—Refunding at maturity of the issue may be done either because the company believes it is a good policy to continue its borrowing, or because the company cannot get the cash funds to pay off the maturing obligation.

Refunding, a good financial policy.—When a company's loan matures, the first question to be asked is: can the business use the funds profitably for a longer period? Generally if it pays to borrow, it pays to continue to borrow. Suppose an obligation of \$1,000,000 matures. Let us suppose also that the company could draw the \$1,000,000 out of the business to pay off the loan. It must first ask itself: can it not with safety earn much more on that \$1,000,000 than it is paying on the loan? If so, the loan should be refunded. To be sure, the business may be very hazardous and it may be the

[3] Notice that this payment of capital must for our purpose be considered an annual charge, since it merely reduces the capital liability to \$1,000,000, the amount that would be due at the end of 75 years on the original 6 per cent bonds.

[4] The exact amount would be \$5,410,074 10 (See Column C of the table which is given on pages 1024–5 of C. W. Gerstenberg, "Materials of Corporation Finance.")

part of wisdom to be rid of the fixed obligation of interest. Each case must be taken as a separate problem in settling that question

The subject of refunding is allied with the subjects of the terms of bonds and sinking fund provisions. How long should a bond run? Should a company prepare to pay off its indebtedness by creating a sinking fund? These questions will be treated at length in another chapter. Here it is sufficient to say that industrials, especially those not dealing in fundamental necessities, must hold out some likelihood of paying off their obligations, while public utilities and railroads finance themselves with the idea of carrying a perpetual debt. We have found that comparatively few industrials are long-lived, while utilities of all kinds must go on as long as civilized localities continue. Hence it is that an industrial must clearly show the advantage of refunding, or must admit that the refunding is a matter of present necessity, which condition it was impliedly promised at the time of the issue of the bonds would not exist when the bonds matured. This statement must be taken with the reservation that the industrials dealing in fundamental necessities may be almost on the same footing as utilities.

Temporary financing—short term notes.—We must now consider some refunding that frequently takes place because of money market conditions. Assume that a company in the usual course of growth is in need of funds, but that on account of high money rates these cannot be borrowed except on difficult terms. Instead of binding itself to these terms for a long period, a company will issue short term notes, hoping that at the maturity of the notes the money market will be in shape to absorb lower interest-bearing bonds. If, however, the money market is still tight, and rates are high, the notes will have to be refunded. This may happen several times in succession. The question may naturally arise: would it not in the first instance have been better to sell long term redeemable bonds, to be redeemed and refunded when the market eased up? The answer to this question will depend on the probable length of the stringency, on the cost of refunding the notes, and on the premium at which the bonds would have to be redeemed. We may imagine a concrete example, thus: suppose 7½ per cent notes to be issued for two years with a selling cost of 2 per cent. Suppose that a 7 per cent bond redeemable at 107 could have been floated at the same cost.

The selling cost of each note or bond would be $20; the annual interest on the note, $75, on the bond, $70, and the cost of calling the bond would be $70. Therefore, if conditions changed at the end of two years, the note would cost $20 (selling cost) plus $150 (2 years' interest), or $170, whereas the bond would cost $20 plus $140 plus $70 (redemption premium), or $230. The note, however, may have to be renewed for another two-year period, and for the four years the cost would be $40 for selling and $300 for interest, or $340, whereas for the same period the bond would cost $20 for selling, $280 for interest, and $70 for redemption—or $370. If another two-year period had to be covered by high interest-bearing securities, the notes would cost an additional $20 for selling and $150 for interest, making a total of $510, whereas the bond expense would be increased by two years' interest only, bringing its total cost up to the same amount, $510. Thus it would appear that if conditions were likely to change in less than six years, the notes would be preferable, whereas if the period of high interest rates were to continue for a longer time, it would be more economical to use the redeemable bonds.

When short term notes are issued in this way, they are usually well secured by a large amount of bonds of an open-end issue that cannot be sold economically at that time Thus the Seaboard Air Line pledged $1,500,000 of its First and Consolidated Gold 6 per cent bonds as security for $1,000,000 of 7 per cent notes that were to run from September 15, 1920, to September 15, 1923

Borrowing on short-term notes may take place when interest rates are low, if other conditions make it advisable. In the late thirties, for example, when stock market conditions were not propitious for the flotation of long-term securities, many corporations negotiated bank loans on low-interest-bearing promissory notes, secured or unsecured. Thus, in 1939 the American Water Works and Electric Co issued and sold to a group of banks $8,000,000 of its secured 3 per cent notes, payable $160,000 semi-annually from the date of issue and the remaining balance five years from the date of issue. Five banks entered into the so-called commitment agreement, under which each agreed to lend a certain part of the total amount. The notes were used solely to discharge outstanding bank loans.

Refunding bonds into notes.—In the above example, whichever instrument was originally used, the plan called for

ultimate refunding into long term bonds. If a bond matures at an inopportune time, short term notes may be used to tide over the bad period or as a means to ultimate payment. Thus the Cuban-American Sugar Company faced in 1917 the maturity, early in 1918, of a series of about $6,000,000 of a total issue of $10,000,000. The company sold $6,000,000 of serial notes to mature $2,000,000 a year, beginning one year after date. This process enabled the company to extend its bonds for gradual cash payment. The yields on the notes were, for the successive years in which they matured, respectively 6⅞, 7⅛, and 7⅜ per cent.

Bondholder's attitude when asked to accept a refunding bond.—We cannot understand thoroughly this subject of refunding unless we know what position the bondholder will take when he is asked to refund. It is all very well to look to the corporation's interest, but the question sometimes must arise: will the bondholders accept the proposal? When a bond matures, the bondholder has the right to demand cash. Usually, cash is offered, but the refunded bond is held out prominently while the cash is held back, much in the way in which, as boys, we used to force the clenched fist with the button in it on the other fellow in order to make him "it" at the game of tag. What should the bondholder do? The simple question for the investor to decide may be worded in this way: here is $1,000; what is the best I can do with it? If the refunding issue is as good an investment as any other, then he should take the refunding bond. If not, he should take his money and invest it elsewhere. Of course, if the bondholder has any other interest in the company, such as that of a stockholder, he may be persuaded by that interest to accept the refunding bond, since a successful refunding reflects a good credit position and thus helps the corporation and all its securities.

When refunding is sought by the company before maturity of the issue, the refunding takes place by redemption of the old bond and the offer of the new bond as the purchase or redemption price. The bondholder has the right to demand cash and again faces his problem as a matter of option between various possible investments. If, however, the bondholder has a security which is not subject to call before maturity, his surrender of the old security and the acceptance of a new one are wholly voluntary. The questions that arise generally

are: (1) what is the relative advantage to the bondholder in accepting the new bond; and (2) if he does not accept, will he injure the company whose obligation he holds, will he kill the goose that lays the golden egg? The advantages offered by the new issue may be (1) better security and (2) wider market. These reasons for refunding were explained in a previous chapter.[5]

Sometimes, however, where a company's earning power is impaired, a new security with a lower rate of interest than that contracted for in the original issue is voluntarily accepted, since it becomes evident that the old rate of interest cannot be continued. When a bond is refunded for this reason, we call the process readjusting.[6]

Inducements to refund.—It is apparent that inducements must sometimes be offered to cause bondholders to accept refunding issues. Some of these inducements we shall mention very briefly.

1. *A cash bonus.*—Thus, in 1933, the holders of the 3-year 6 per cent notes of the Greyhound Corporation were offered a cash bonus of $20 for each note, and an additional $5 if the deposit was made before January 1, 1933. The effect was that of paying the noteholders the $1,000 to which they were entitled and then selling them the new notes at 97½.

2. *Higher rate of interest.*—Most of the refunding operations of 1931–1933 involved the payment of a higher rate of interest. A higher rate may result from an offer of the company to pay a part of the bondholders' income tax on the interest received. To induce the bondholders to extend the

[5] See pages 228 *et seq*

[6] See chapters on reorganization

[7] An interesting example of how a company will sometimes "try on" a low rate in its refunding issues, came to light in an investigation of the street railway situation in Boston by a committee of the Massachusetts Legislature in September, 1917 President Brush, of the Boston Elevated Railway, described attempts by the West End Railway, the lessor, [see C. W. Gerstenberg, "Materials of Corporation Finance," pages 555–569] to sell an issue of $1,581,000, 6 per cent bonds These bonds, Mr Brush said, were to refund, in part, loans originally made in the years from 1900 to 1904, amounting to $4,743,000, carrying 4 per cent interest The original bonds sold at a premium, prices being from 101.536 to 104 69 They came due in 1915 and were refunded for one, two, and three years at 5 per cent and sold at a premium. In 1916 the first year's portion came due and was again refunded at 5 per cent On August 1, 1917, the second year's portion came due Bids for 6 per cent bonds were invited from thirty-one different reputable banking firms Not a bid was received. An offer of new bonds bearing 7 per cent interest brought a bid of 100 14.

bonds which matured on February 1, 1921, the Birmingham Water Works Company offered to pay a bonus of $50 on each $1,000 bond and also agreed to pay the normal Federal income tax to the extent of 2 per cent.

3. *Partial payment.*—The bondholders may be offered the option of taking bonds par for par or of accepting a partial payment in cash and the rest in the refunding issue.

4 *Agreement to create a sinking fund.*—The Manila R. R. in 1917 held out this inducement for a twenty-year extension of its bonds, though in fact the bonds were not to mature for twenty-two years. The reason for this anxiety to get the extension lay in the low rate of interest on the bonds and the unlikelihood that the bonds could be renewed on such a favorable basis when they matured in twenty-two years.[8]

5. *Wider market for the new securities.*—Because they are to be of a larger issue and are to be listed on the exchanges.

6. *Better security* [9]

7. *Guaranty by a parent company* which has acquired the issuing company as a subsidiary. Thus the American Woolen guaranteed the refunded notes of the Ayres Mills in 1917.

8. *Offer to the general public* of the refunding bonds, with "preference" to the holders of old bonds. The advantage of this plan is its good psychology.

Refunding with aid of bankers.—Even with all these inducements, corporations usually engage bankers to insure or underwrite the refunding operation. When this practice is followed, the company generally announces the terms of the refunding and the banker adds a statement of his readiness to pay cash if the bondholder desires cash instead of the new bond. The mere fact that the bondholder can have the cash if he wants it is one good reason why he will accept the new security.[10]

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[8] The plan apparently failed for lack of consent of the stockholders They simply took no interest in the matter—a good illustration of the carelessness of stockholders

[9] This point was fully covered in Chapter XIII, pages 230 *et seq*

[10] For an illustration of the announcements made, see C W Gerstenberg, "Materials of Corporation Finance," pages 320–321 For an illustration of an attempt to refund without the aid of a banker, see *ibid*, page 1009

CHAPTER XVI

EXTINCTION OF BONDED INDEBTEDNESS—REDEMPTION

Redemption; meaning and kinds.—By redemption is meant the exchange of bonds for cash Redemption may take place (1) at maturity of the bonds, as provided in the contract covering the bonds, or (2) at the option of the issuing corporation, before maturity but under the terms of the contract, or (3) before maturity and not under the contract, but as a result of a subsequent agreement. In this last case, the agreement to give up the bond for cash may simply amount to a purchase of the bond by the company in the ordinary course of security transactions—that is, through the stock exchange or through an investment house—or it may be the result of negotiations made directly between the company and its bondholders. The distinction between these two methods lies in the fact that where the bond is bought through a broker or investment house, the bondholder is not apprised that his bond is being bought by the company for redemption, while in the case of negotiation he knows that the company has funds of which to dispose The effect of these methods on the company will be considered later.

Where the trust deed under which the bonds were issued gives the company the option to redeem before maturity and the bonds are redeemed by lot under this provision, the redemption may be called "mandatory." Redemption by subsequent agreement may be termed "solicited."

Purposes of redemption.—A number of different reasons may prompt a company to rid itself of the obligation of an issue or part of an issue. These reasons are important enough to demand separate though brief consideration.

Redemption for sinking fund.—We have seen that bonds may be issued as unsecured promises to repay a loan or as promises secured by a lien on the property of the company. Frequently, a still further guarantee of future payment is

given through the creation of a separate fund accumulated out of the earnings of the company and set aside for the specific purpose of redeeming the bonds before or at maturity. The methods of building up and handling sinking funds we shall consider later. Here we merely wish to indicate that bonds are often redeemed as a means of investing the sinking fund.

Redemption as a step in refinancing.—Redemption is frequently the first step in a refinancing plan.[1] For example, if a company has a small underlying issue that might interfere with the sale of a large issue of subordinate bonds, the underlying bonds may be redeemed to clear the property and thus prepare it for the lien of the larger issue.[2]

Redemption as a step in refunding.—Redemption, we have seen,[3] may be used as a means of aiding a refunding operation. Those bondholders who will not take the refunded issue may be compelled to surrender their bonds for cash, the refunding issue itself being used to obtain the cash.

Redemption as a means of eliminating fixed charges.—The income of some forms of industry is so unstable that the burden of a fixed charge is a constant menace. Whenever bonds have been sold in periods of need, the first opportunity is seized, after prosperity has endured long enough to build up profits, to pay off the bonds. Thus, in the late twenties, the United States Steel Corporation retired a large part of the funded debt of the company and its subsidiaries, thereby saving during the following period $31,000,000 per annum, including annual bond redemption requirements. The importance of this step was summed up as follows at the 1937 annual stockholders' meeting:

> "You can readily see, if the net loss of assets from operations and such moderate dividend distributions as were made through the depression period was $50,000,000 for the period beginning in 1928 and extending to the end of last year, that if we had had to care for an additional cash requirement of $31,000,000 a year for seven of the nine years, it would have created a very distressing situation."

Redemption as a means of avoiding onerous terms.—Bond issues which were made at a time when later developments

[1] An interesting case of the dependence of corporate financing on redemption—the financing operation consisted of the consolidation of several companies—is outlined in the Report of the Interstate Commerce Commission to the Senate of the United States. See C. W. Gerstenberg, "Materials of Corporation Finance," pages 549–554, especially page 551.

[2] This process has been described on page 235.

[3] See page 258.

could not have been foreseen are likely to contain terms that are extremely disadvantageous to the corporation or to its stockholders. Such issues must be retired as quickly as possible. Thus, in 1938, the United States Rubber Co. 5's were replaced with an issue of 4¼ per cent bonds to eliminate the restriction in the indenture that the company could not pay dividends except from earnings subsequent to December 31, 1916.[3a] With the restriction out of the way, the company was able to eliminate the accumulated deficit by methods described on page 578, and clear the way for stockholders to obtain some benefits of their ownership in years of good profits. Another example is the following: the bondholders may have enjoyed a fair rate of return during a long period while the stockholders lived on prospects. The company may then spring into great prosperity and the stockholders may see the large profits for which they waited suddenly reduced by the conversion of an issue of convertible bonds into stock. Thus, in the early part of May, 1917, the Lackawanna Steel Co., so it was reported in financial circles, began the purchase of its convertible bonds of 1950 in order to preserve for its stockholders the unprecedented profits growing out of its war contracts. In this case the bonds were redeemable at 105, but the company began the purchase of them in the open market at a lower price. During the rise in common stock values between 1925 and 1929, many companies put a stop to the conversion of bonds by calling for redemption such bonds as had not yet been converted.

How about the holder of the convertible bond? some readers may say. Did not the holder of the convertible bond purchase it with just such a contingency in mind? If the conversion of the bond into stock never could become profitable, why issue a convertible bond?

To meet this objection, it is usually provided that the bondholder shall have some time after notice of redemption to determine whether he will accept the cash or elect to convert. Frequently, the last day for conversion is the date set for redemption.

Redemption as a means of investing cash.—A company will often have surplus cash on hand shortly before the

[3a] The saving of ¾ of 1 per cent interest did not compensate the company for the expense of retiring the existing bonds, because of the premium for redemption and other costs.

maturity date. Instead of investing this cash, paying the commission for purchase of the investment securities and again for their resale when the cash is needed at the maturity of the company's own bonds, in the meantime standing the risk of loss—the company must sell the investments in time to use the cash, however the investment market stands at the time—the cash is used to redeem the bonds before maturity. This procedure may be followed even though it is necessary to pay a premium to assure the retirement of the bonds. However, money may be lost by paying a premium when, by waiting a year or so, the premium might be avoided. Thus on January 1, 1918, a certain company redeemed 5 per cent bonds at 105. The bonds had three years to run. The cost of redemption per year, omitting compound interest calculations, was 1⅔ per cent. In other words, if the company could have made a good investment at more than 3⅓ per cent (adding possibly a tenth for expenses), it would have paid to make the investment for the three-year period, at the end of which time the investment could have been sold for cash to get the funds for redeeming the bonds at maturity. However, it must be remembered that the risk involved and the uncertainty of the financial weather in the early part of 1918 probably made it advisable to use the cash for the elimination of the bonded indebtedness instead of using it to save a possible one per cent by investment.[4]

Redemption as a credit tonic.—Perhaps most people have a horror of debt. They do not realize its beneficence. A debt means trading on the equity, which, as we have seen, magnifies the profits and the losses. A thoroughly capable management can generally be relied on to make profits. Again, a debt is an incentive to work to make ample provision for the interest payments. The mere fact that there is a responsibility to bondholders may keep up the tone of the administration. However, people do think of debts with abhorrence. We pic-

[4] In 1917 United States Rubber redeemed some 6 per cent and 5 per cent bonds not much more than a year before maturity and at a premium of about 2 per cent In paying the bondholders their money, it was announced that the purpose was to enable them to buy Liberty Bonds It would have been manifestly to the disadvantage of the company to pay 6 per cent on its own bonds and to use the funds it had for their redemption in 4 per cent government bonds. No lack of loyalty and patriotism was shown, since the identical money was available to the government, the only question being whether the company should furnish it directly or through its bondholders.

ture in our mind's eye the burning of the church mortgage. Corporations announce with pride that "with this payment, the company will be entirely free from debt" It is common to find in financial newspapers and financial news tickers such expressions as "the retirement of the convertibles, it is felt, will put the stock in a very strong position,"[5] or "an announcement that trustees would buy, at not over 103½, $1,000,000 of the outstanding 6 per cent bonds of the Merchants and Miners Transportation Co. had a favorable effect on the stock of the company. This sold at 70 and was in good request at slightly under this figure."[6]

Contract of mandatory redemption.—Having given the principal reasons for redeeming, we may now turn to the financial processes involved in redemption. The provision in a mortgage or deed of trust giving the company the right to redeem may be outlined briefly. Usually, the company must redeem at an interest date or at some other fixed time. The purpose of this provision is to give the bondholder an opportunity to inquire, without constant worry, into the status of his holdings. The Seaboard Air Line Ry. First and Consolidated Mortgage 6's, Series "A," of 1945, are redeemable on any interest date on sixty days' notice, while the Convertible Debenture Gold 5½'s of the Associated Gas & Electric Company are redeemable on the first day of any month on sixty days' notice.

Notice of redemption is generally required, as is illustrated by the examples given in the previous paragraph. The notice usually is given about sixty days before the redemption date, although it may run as long as ninety days or may be as short as two weeks. Sometimes a minimum and maximum number of days' notice is mentioned. For example, the Wilson & Co. convertible 3¾ per cent debentures due 1947 are redeemable at any time on thirty to fifty days' notice. In the case of registered bonds, the notice should be sent to the bondholder at his last known address. In any event, the contract should provide for newspaper publication and the newspaper should be indicated. A typical provision is as follows:

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[5] A Dow, Jones & Co ticker announcement of the retirement of Lackawanna Steel bonds

[6] *Baltimore Sun*, July 26, 1917.

In case the Company shall desire to exercise such right to redeem and pay off such entire issue of bonds, it shall advertise in two daily newspapers of general circulation, one published in the Borough of Manhattan in the City of New York and one published in the City of Chicago, Illinois, at least once a week for four successive weeks (the first publication to be not less than thirty days and not more than forty days before the date of redemption specified in such notice), stating that the Company has elected to redeem and pay off all of the bonds and that on such interest-payment date there will become and be due and payable upon each of said bonds at the financial agency of the Company in the Borough of Manhattan in the City of New York the principal thereof together with the premium as aforesaid and accrued interest to such date A similar notice shall be sent by the Company through the mails postage prepaid at least thirty days prior to such redemption date to the registered holders of bonds whose addresses shall appear upon the transfer register Upon such advertisement of such notice the entire issue of bonds shall become and be due and payable on the interest-payment date designated as the day of redemption in said notice, together with the premium of five per cent on the principal thereof and all interest which shall have then accrued and be unpaid.[7]

Frequently, the issue is retirable only as a whole, except generally for sinking fund purposes, in which latter case, as we shall see, the company may retire each year enough bonds to use up its sinking fund payment. Sometimes less than all the bonds, but not less than a certain specified amount, may be redeemed at one time. Thus the provision for redemption in the mortgage securing the General and Refunding Mortgage 5's of 1942 of the Pacific Gas & Electric Co. permitted redemption in blocks of not less than $500,000.[7a] Obviously, proper notice can be given when $500,000 of bonds is to be redeemed, whereas newspaper advertisement, for example, would be an extravagant detail in the redemption of a single $1,000 bond.

The price at which the bond is to be redeemed is stipulated. This may be par, although usually a premium is provided for. The Pacific Gas & Electric Co. bonds noted in the previous paragraph were redeemable at par when redeemed as a whole, though redeemable at 105 when redeemed in blocks. The premium may be graduated. Some examples of graduation will serve to illustrate the practice:

The Ohio Electric Power Co. first gold 5's, series due 1957, are redeemable at 105 to June 1, 1937, inclusive, and thereafter on any interest date at a price decreasing at the rate of ¼ per cent yearly, to maturity.

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[7] From Jones & Laughlin mortgage See C. W Gerstenberg, "Materials of Corporation Finance," page 222

[7a] The bonds were redeemed in 1937.

Traction Terminal Corp. first mortgage gold 5's, due 1957, provide an increasing redemption price The bonds are redeemable at par up to July 1, 1937, at 102 thereafter to July 1, 1947; and at 103 thereafter to maturity.

Sometimes the premium is made at one rate when the purpose is merely to get rid of the bonds and at a lower rate when the purpose is to get an investment for the sinking fund. Thus, Baldwin Locomotive Works 5's of 1940 are redeemable at 115, but at 107½ for sinking fund purposes

In the year in which bonds are redeemed, the excess of the redemption price over the sum of the issue price and the amortized discount becomes a deductible expense for Federal income tax purposes. For example, if company *A* in 1936 issued bonds at 80 (that is, at $800), to mature in five years at 100, and for each of the years 1937 and 1938 set aside from earnings $40 to reduce the bond discount, and then in 1939 redeemed the bonds at 105, it could claim as a deductible expense as to each bond redeemed, the difference between $1050 and the sum of $800 plus $40 plus $40, or $170. Under this ruling, the net amount of bond discount in any case where bonds are issued at less than par should be prorated over the life of the bond and a proper deduction from income should be made each year before reporting to the government the corporation's taxable net income. In the same way, if the bonds are issued at a premium, the gain should be prorated over the life of the bonds and an appropriate amount should be included in taxable net income each year.[8]

Technique of payment.—The money for redemption is usually deposited with the trustee. If the bonds are properly redeemed under a mandatory provision in the mortgage, interest ceases to run from the redemption date.[9] Since the trustee holds the money *for* the bondholders and not *adversely*, the statute of limitations will not run on the debt if the bondholders fail to make application for their money.[10] For this

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[8] See Baldwin Locomotive Works v McCoach, 221 Fed 59, Vol. I "American Federal Tax Reports," page 450

[9] See notice of redemption in C W Gerstenberg, "Materials of Corporation Finance," page 336

[10] Usually a debt is outlawed in six years, or if owing on a sealed instrument, in twenty years But where the money for redemption is turned over by the company to the trustee, it is no longer "owing," since, as indicated in the text, the trustee holds in behalf of the debtor and not in behalf of the creditor

reason the later mortgages provide that after a certain number of years the money, if unclaimed by the bondholder whose bond has been called, shall be returned to the company. In such event the debt would probably in most jurisdictions be outlawed in twenty years

Disadvantages of redeemable bonds.—We have seen that interest ceases from the redemption date Thus a bondholder may lose interest on his capital before becoming aware of the redemption of his bond. The bond is likely to be redeemed by the corporation at a time when prices and interest rates are low, that is, when the purchasing power of the dollar is high The bondholder who purchased at a time when interest rates were high would be in an advantageous position if he could keep his bond during a period of declining price. This advantage is frequently lost by redemption. The greatest difficulty for the investor is the expense of reinvesting the funds, as well as the risk involved in finding a new security that will pay fair income and still be reasonably safe. If the bonds are redeemed at a time when investment funds are plentiful, it will be difficult to place the proceeds of the redemption at a high rate of interest. To offset these disadvantages, the redemption premium is provided. Just how large the premium shall be is a matter to be determined by the company in providing a contract that it thinks will attract investors. If any rule can be laid down, perhaps it is that the premium should amount to one year's interest, which would compensate the bondholder for a possible loss of interest through neglect to claim his money when the bonds are called and would also give the bondholder one year to look around and find a good investment.

Another disadvantage of the redeemable bond is the nuisance of watching for notice of redemption. In practice this difficulty is obviated by investors who turn the care of their investments over to investment bankers who keep indexes of issues, as bonds are called, these bankers look at their index, turn in bonds whose numbers have appeared on the roll of called bonds, collect the redemption price, and reinvest the proceeds. The commission made on the latter part of this transaction is the compensation the banker gets for all his trouble.

Redemption of serial bonds.—In the case of serial bonds, the provision for redemption frequently includes a clause for

the calling of bonds in the reverse order of their maturity. Thus the issue may provide that the last maturing bonds are to be called first, at par plus a premium of 1 per cent for each year of the unexpired term. From the standpoint of the bondholder this arrangement would seem objectionable, since one who selected a later maturing bond evidently wished a longer term investment, while he who selected an early maturing bond was anxious to get his money back quickly. The company follows the practice, of course, in order to accelerate cancellation of the entire indebtedness Usually, the company pays a higher premium on the bonds redeemed longest before maturity Thus the American Fruit Growers, Inc., pays a premium of 1 per cent on redemption of its 7 per cent serial convertible gold notes maturing within five years, 2 per cent on those maturing in from five to ten years, and 3 per cent on notes maturing more than ten years after the redemption date

Intercompany redemptions.—Frequently, a company guarantees the bonds of its subsidiaries but demands in return the right to redeem the issue. This provision is wise, since later it may be advisable to consolidate the companies and to refinance the new company under one large mortgage, the bonds issued under which will bear perhaps a relatively low rate of interest. This low rate will be made possible because the new bonds will be well-known as part of a very large issue and will thus have the desirable investment quality of marketability [11]

[11] See Washington County Ry $3\frac{1}{2}$'s guaranteed by the Maine Central, and Houston, East & West Texas Ry 5's of 1933

Chapter XVII

SINKING FUND AND SERIAL BONDS

Purposes of sinking funds.—A sinking fund, as the term is used in this chapter, is a fund created from earnings for the purpose of reducing or retiring bonded indebtedness Since the fund is frequently turned over to the trustee, it may be looked upon as a security held by the trustee for the benefit of the bondholders, and to the extent that the fund is invested "in the same issue," it actually ceases to be a fund but amounts to a partial extinction of the debt.

Where the fund is created to take the place of "wasting assets," such as timber, oil, and ores, it is usually and more properly called an amortization fund [1]

All mortgages do not provide sinking funds. If a company has a business the demand for whose products is likely to endure indefinitely, a sinking fund will not be necessary, provided, of course, the value of the assets is kept up by proper repairs and replacements. Thus it is that the older railroad mortgages seldom contain provisions for sinking funds, since their bonds can be renewed indefinitely. It is customary to have sinking fund clauses in industrial mortgages, while such clauses for companies with wasting assets, such as mining, oil, and timber companies, are absolute necessities [2]

[1] The reader should carefully distinguish between a "reserve" and a "fund" A fund is an actual asset and appears in the statement of the company among the other assets. To prevent its use for any purpose other than that for which it is intended, it is "protected by a reserve"; that is, on the liability side of the balance sheet a "sinking fund reserve" is set up This reserve diminishes the surplus and prevents payment of dividends which otherwise might be distributed if the "fund" were "balanced" by the surplus and not by a reserve If we set up a "reserve" for payment of the bonded indebtedness without actually setting aside a definite fund, the result is that the equity behind the bonds is thickened and maintained While this equity—that is, the assets representing the excess of total assets over bonded indebtedness—cannot ordinarily be used, in the form in which it is found at the maturity of the bond, to pay off the indebtedness, the thickened equity does serve to improve the credit of the company and to assure refunding In other words, where a reserve instead of a fund and a reserve is used, the object usually is to "refund" instead of to "redeem"

[2] This book is not the place to discuss the economic question of whether all mortgages should contain sinking funds The viewpoint is assumed here

Sinking funds were used in early railroad bond financing, but they went out of fashion during the railroad defaults at the end of the nineteenth century.[3] However, they have become quite popular again in connection with industrial bonds. The advantages of sinking funds may be briefly summarized as follows:

1. They tend to inspire confidence, since they give assurance that the obligation will be met before or at maturity.

2 Even if the sinking fund is not sufficiently large to amortize the debt at maturity, the remaining debt can be more readily refunded than could the full obligation of the original issue.

3. Sinking funds tend to improve the management of the company by requiring a definite amount of capital investment out of earnings each year.

4. Since sinking funds are usually invested in the bonds of the issue they protect, a market is maintained for the purchase of the bonds and the bonds therefore will tend to sell on the open market at the redemption price. While this advantage primarily accrues to the persons who invest in bonds, the benefits will also be enjoyed by the company in the form of good credit rating.

Difference between sinking fund and serial bonds.—Since, as we shall see, most sinking funds are invested in the bonds of the issue which they protect, a sinking fund bond is very much like a serial bond—that is, a bond issued with others, all of which are to be retired in a series of groups.[4] In the case of the sinking fund bond, however, we cannot tell at the time of issue whether bond number 1 will be retired as a part of the investment of the first installment of the sinking fund or whether it will remain outstanding till final maturity of the whole issue. In serial bonds, on the other hand, we know that

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that capital is to be regarded as perpetual That it is not so perpetual is well recognized If, however, a business is properly managed, capital can replace itself indefinitely out of its own product But if capital is inefficiently managed, it will disappear; the mismanagement may consist of unwise investment or commitment, or incompetent use by those to whom the commitment is made.

[3] "It came to be realized that sinking fund accounts could be subject to manipulative tactics which would render them a source of expense and loss of credit, rather than of income and confidence" L. Chamberlain, "The Principles of Bond Investments," page 86

[4] Serial bonds must be distinguished from bonds designated as Series "A," "B," etc, that are issued under large open-end mortgages.

bonds numbered, say from 1 to 100, will mature in one year, those numbered from 101 to 200 in two years, and so on

But this apparently slight difference is more important than it seems. We may assume two issues of bonds, each for $1,000,000: one issue, which we call "A" bonds, is protected by a sinking fund providing for the setting aside of $100,000 a year to be invested in bonds of the issue at par; the other, called "B" bonds, we may assume is a serial issue of the same amount, the series consisting of 10 groups of $100,000 each, one group maturing each year. The "A" bonds would be regarded as a ten-year investment. If the company should neglect to set aside the $100,000 in any year for the sinking fund, the bondholders might not be aware of this fact, and if the trustee were lax, the entire issue might run to maturity without the protection of the sinking fund.[5] However, the bondholder of a serial issue knows definitely when his money should be returned, and if it is not forthcoming on the due date, he can enter immediate protest to the trustee. Thus it is that for bonds protected by assets of a restricted use—for example, railway rolling stock which necessarily must be exhausted and cannot well be kept up to original value by repairs—the serial form is more likely to be used than the sinking fund

One disadvantage of serial bonds is that where they do not sell at par, each group of the series must be sold at a different price to make a uniform yield In a very rough way, if a group of 6 per cent bonds maturing in one year sells at 98, the group maturing in two years will have to sell at 96 to give the same yield, for in each case the yield would consist of 6 per cent of nominal interest and $2 a year through appreciation of the principal investment, which will be worth par at maturity. In practice, of course, the calculation is made with greater nicety. On the other hand, by quoting different prices for different groups of the series, the corporation is able to adjust both the price and the yield to the requirements of the investment market.

Sinking funds as supplementary to serial bonds.—It must not be thought that serial bonds cannot contain sinking fund provisions. Indeed, a moment's thought will show how neces-

[5] If the indenture under which the bonds were issued conformed with the Trust Indenture Act of 1939, there would be a provision in it requiring reports by the trustee to the bondholders which would reveal the failure of the corporation to make the sinking fund payments. See page 207.

sary the sinking fund may become. For example, the Long Bell Lumber Co. in 1907 got out a serial issue of \$9,000,000, the groups for a number of years maturing in \$300,000 lots semiannually, and thereafter in \$325,000 lots semiannually But in a given year the company might cut considerably more timber in proportion to its entire holdings than is represented by the number of bonds maturing in that year in proportion to the entire issue. Hence the mortgage of that company provides that the company must deposit with the trustee \$3 50 per 1,000 feet, log scale, for all timber cut and manufactured into lumber, as a sinking fund to retire the principal of the issue. Should the deposit exceed the amount of bonds maturing in any year, the trustee is required to purchase or call for redemption, at a premium of 1½ per cent, the unmatured bonds to an amount sufficient to exhaust this surplus. To show how this provision works, we may give the status of the issue in 1920:

Authorized	\$9,000,000
Outstanding	\$ 989,500
Retired by maturities	7,606,500
Retired on account of excess cut and release of land (March 19, 1920)	404,000
	\$9,000,000

Voluntary sinking funds.—Sometimes sinking funds are started by corporations as a matter of expediency after the bonds have been running for some time. The setting aside of such a sinking fund as a voluntary proposition is usually regarded as a sign of strong financial position.

In the annual report of the Central Leather Company for the year ended December 31, 1913, will be found this statement

> Your directors deem it desirable now that substantial provisions should be made towards the retirement of the outstanding bonds of your company at the date of maturity, April 1, 1925, and that a portion of the stumpage moneys (which represent timber cut and are not profits or available for dividends) should be applied to that purpose They have decided to set aside moneys at the rate of \$750,000 to \$1,000,000 annually out of these stumpage moneys to be accumulated in a special fund and invested in the purchase of the Company's bonds or other equally high-grade securities as may from time to time be deemed expedient. It is contemplated that the income from these investments shall not be treated as a credit to the general Profit and Loss account of your Company, but shall be regarded as a special depreciation provision.

It will be noted that here the sinking fund is entirely gratuitous as far as the bondholders are concerned and that the company therefore may at any time discontinue it.[6]

In 1917 the New Orleans Great Northern R. R. Co. announced that it would set aside 20 per cent of its annual net earnings in a voluntary sinking fund for the redemption of its 5 per cent bonds.

Sinking fund as a consideration for change in bonds.—As a consideration for some concession, a sinking fund may be promised to bondholders holding bonds under a mortgage that makes no provision for a sinking fund. For example, the Philadelphia Company wanted to make its 5's of 1949 redeemable. We find, therefore, in the *New York Times*, March 6, 1917, an advertisement from which the following paragraphs are taken:

At the suggestion of the bankers whose names appear below, the Philadelphia Company, by appropriate corporate action, has agreed that upon assent by deposit, on or before May 1, 1917, of at least 85 per cent of the $6,500,000 of the Philadelphia Company's outstanding First Mortgage and Collateral Trust 5% Gold Bonds, due March 1, 1949, said Philadelphia Company will enter into a Sinking Fund and Redemption Agreement with the Provident Life & Trust Company of Philadelphia, Trustee, which shall provide as follows

1. For the creation of a sinking fund of 2 per cent per annum

The Company will agree to pay to the Trustee a sum equivalent to 2 per cent per annum of the principal amount of so many of the bonds of this issue as may be made subject to said Sinking Fund and Redemption Agreement payable in annual installments on and after March 1, 1918, for the purchase and cancellation of bonds of this issue which shall have become subject to said Sinking Fund and Redemption Agreement. Tenders of bonds will be requested by public advertisement.

2. For the establishment of a callable price of 107½ and interest.

In consideration of the creation of the above Sinking Fund, the Company shall have the right (a) to call by lot bonds of this issue which shall have become subject to the above-mentioned Agreement, for the Sinking Fund, at 107½ and interest, providing sufficient bonds shall not have been tendered in response to the Sinking Fund advertisement, (b) to call for redemption or purchase at 107½ and interest, on thirty days' notice by public advertisement, all of the bonds of this issue which shall have become subject to said Agreement. In case the bonds are called as whole, they may be cancelled or kept alive, as the Company may elect

[6] Commenting on this arrangement, the *Wall Street Journal* for August 8, 1917, said that it was "an indication of the conservatism of the management." On December 31, 1922, this sinking fund amounted to $11,395,000 The issue was authorized for $45,000,000, $24,648,750 of which was issued.

Except as above specified in paragraphs 1 and 2, the rights of bondholders shall in no way be affected. The security for the bonds shall remain unimpaired

The Company reserves the right to extend the time for the deposit of bonds, and also the right to declare the plan operative in case less than the specified percentage of bonds shall have been deposited.

The Equitable Trust Company of New York, as Agent for the Depositary, will issue transferable receipts against the deposit of bonds, in transferable form, and non-transferable receipts for bonds registered as to principal and not endorsed for transfer to bearer or accompanied by a power of attorney for such transfer.

If the plan does not become operative, the bonds deposited, or an equal par value thereof, will be returned to the holders

If the plan becomes operative, the deposited bonds and attached coupons will be stamped as being subject to said Sinking Fund and Redemption Agreement.

Sinking fund payments to begin in future.—The sinking fund liability is a charge that must be met before the profits of the year can be turned over to the stockholders as dividends. Frequently, a company will not find itself in a strong enough position to pay these charges immediately. The capital assets into which the proceeds of the bonds have been turned will not be immediately productive. The mortgage may provide, therefore, that payments need not be made till some time in the future,[7] or until another sinking fund bond that has a prior claim on the earnings has been redeemed;[8] or it may provide that the directors may waive payment in the early years.[9]

The two problems of sinking funds.—Granted that a company decides to use a sinking fund, there are two fundamental questions which it must answer before drafting its mortgage. The first question is. how shall the sinking fund be built up; and the second is: what shall be done with the fund? Many subsidiary points grow out of these two questions, but they are all mere variations of the same problem.

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[7] Sinking fund payments of the Lake St. John Power & Paper Co Ltd, first $5\frac{1}{2}$'s, dated July 1, 1936, were not to begin till July 1, 1940.

[8] The Jefferson & Clearfield Coal and Iron Company agrees in its Second Mortgage 5's, dated June 15, 1896, to begin to set up a sinking fund as soon as its first mortgage is retired See also the Lackawanna Steel Company 5's of 1950

[9] The mortgage securing the First Mortgage 5's of 1931 of the Pensacola Electric Company permitted the directors to waive the first five annual installments of the sinking fund.

Total amount of sinking fund.—The first question will be determined somewhat by a consideration of how large the sinking fund must be at the time the bonds mature. To be sure, in most cases the sinking fund is so arranged that it will completely extinguish the bonded indebtedness at maturity. But there are times when it is planned that the bonded indebtedness shall not be entirely paid off at maturity, but shall be refunded A reduction of the indebtedness, however, by means of a sinking fund, will insure the refunding process. Thus the Libby, McNeill & Libby First Sinking Fund Gold 5's, due 1942, contain a provision for a sinking fund that will be sufficient to retire 35 per cent of the issue by maturity. The Poor & Co. debenture 4's of 1946 are protected by a sinking fund that will retire about 66⅔ per cent of the issue by maturity. When the sinking fund is planned to approximate, at maturity, the amount of bonds, the likelihood is that the difference between the total obligation and the sinking fund will be provided from the general surplus; that is, the sinking fund is made up mostly out of payments made in required amounts at stipulated times, and partly out of payments held in the surplus from time to time [10]

At what rate shall the sinking fund grow?—Sinking fund payments may be set aside in amounts as follows

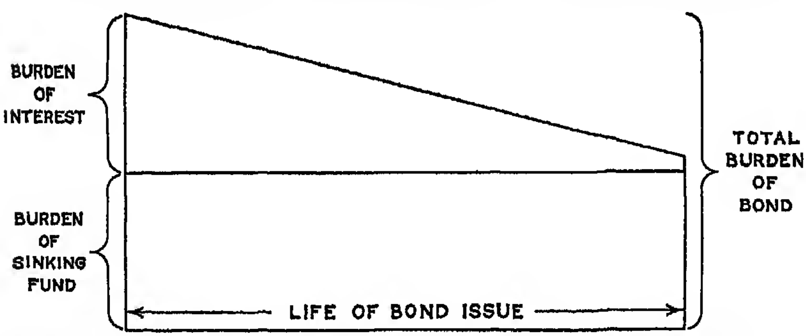
1. Fixed annual amounts
2. Sinking fund arranged to constitute with interest on bonds a fixed annual burden.
3. Installments of increasing size.
4. Installments, part fixed and part based on earnings.
5. Variable arrangements for different series under the same mortgage.
6. Installments proportioned to number of bonds issued under present and prior mortgages.
7. Installments variable with earnings but with fixed minimum.
8. Installments varying with profits.
9. Installments varying with amount of depletion.
10. Installments varying with amount of business.
11. Installments conditioned on payment of dividends.
12. Installments conditioned by current financial position.
13. Payments from proceeds of sale of released property.

[10] The Remington Rand, Inc sinking fund for its 4½ per cent debentures of 1956 will provide for 60 per cent of the issue

14. Payments from exercise of stock purchase warrants.
15. Optional sinking funds
16. Cumulative and non-cumulative sinking funds.
17. Special funds for interest.

1 *Fixed annual amounts paid into the sinking fund.*—The simplest form of sinking fund is that which requires a stated amount to be paid into the fund each year The 3¾ per cent Series "D" of 1961 of the Inland Steel Company require a payment of $700,000 to the trustee, not in cash but in bonds of the protected issue at their face value. The Battle Creek Gas Co. issued some bonds in 1936 requiring a sinking fund payment sufficient to retire $10,000 principal amount of the bonds annually. The Debenture Gold 5's, 1953, of United Drug Co. require an annual flat payment of $750,000 to redeem bonds at a price not exceeding the redemption price Provisions for fixed annual payments are not so common in large modern mortgages as variable sinking fund payments, but they are still frequently found in small issues.

2. *Sinking fund payments arranged to constitute with interest on bonds a fixed annual burden.*—Some sinking funds are so



Effect of Retirement of Bonds Through Operation of the Sinking Fund on Annual Burden of the Issue

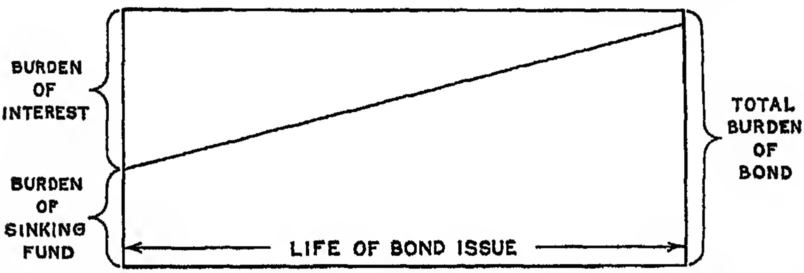
arranged that the payments when added to interest on the bonds constitute a fixed annual burden. The theory on which such arrangements are based is that since the company gets the same benefit from the borrowed money year after year during the life of the bond, the earnings of the company should each bear the same total burden—that total burden being made up of interest and of sinking fund requirements.

Usually, as we shall see farther on, payments into a sinking fund are invested in the bonds of the issue which the

sinking fund is designed to protect [11] The effect of this investment is to retire the bonds and thus to decrease the annual burden of interest If the sinking fund payment remained fixed, the combined burden would gradually decrease, as is shown in the diagram on page 282.

The disadvantage of this arrangement is that it places a heavy burden on the company's earnings in early years at the time when the company is probably least able to bear it

Modern mortgages, therefore, usually provide that as the interest burden decreases, the sinking fund burden shall increase proportionately. This effect may be brought about



How Annual Burden of Issue May Be Kept Uniform by Increasing Sinking Fund Installments as Interest Decreases

in different ways. For example, the mortgage may read that to the fixed annual payment into the sinking fund there shall be added "a sum equal to the annual interest upon all bonds which have up to that time been purchased or called for payment by the trustee" Sometimes the same effect is produced by providing that bonds purchased for the sinking fund shall not be canceled, but that the interest on them shall be paid to the trustee, who shall add such interest to the regular sinking fund payment. A simple arrangement is that of the Jones & Laughlin Steel Company's mortgage which secured its 5's of 1949; it provided that if $15,000,000 or less of the bonds is issued, the company shall pay into the sinking fund the difference between $1,000,000 and the interest on the outstanding bonds, whereas if more than $15,000,000 is issued, the payment shall equal the difference between one-fifteenth of the bonds issued and the interest on the outstanding bonds.[12]

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[11] See page 297

[12] See C W Gerstenberg, "Materials of Corporation Finance," pages 183 *et seq*

3. *Sinking fund installments of increasing size.*—Some examples of increasing amounts are as follows: The annual sinking fund payments for the protection of Otis Steel Co First Sinking Fund, series A, 4½'s due 1962, range from $300,000 in 1937 to $474,000 in 1960. Similarly, the Cumberland County Power & Light Co. first 3½ per cent series, due 1966, require an annual sinking fund payment of ½ of 1 per cent of the outstanding bonds from October 1, 1937 to October 1, 1946, inclusive, 1 per cent from the latter date to October 1, 1956, inclusive, and 1½ per cent thereafter to maturity.

In open-end mortgages, since it is not possible at the time of the drafting of the mortgage to know whether and when all the authorized bonds will be issued, it is customary to state the annual sinking fund payment as a percentage of the total bonds issued. The American Ice Co. debenture gold 5's, due 1953, provide for an annual sinking fund payment at the rate of 2½ per cent of outstanding debentures.

The Brown Co. first sinking fund gold 5½'s, series A, due 1946, require annually, beginning April 1, 1927, payment into the sinking fund of an amount sufficient to retire by purchase at an amount not exceeding redemption price, or, if not so obtainable, by call at that price, the following amounts of bonds. $400,000, 1932–36, $600,000, 1937–41; $800,000, 1942–44, and $1,600,000, April 1, 1945. Bonds may be tendered in lieu of cash

Wheeling Electric Co. 5's of 1941, dated 1911, began payment in 1916, and required annually thereafter an amount equal to 1 per cent of the outstanding bonds, increasing ½ per cent each fifth year up to 3 per cent, and after 1930, in such years as the earnings are three times the bond interest, the payment will be 2 per cent

Associated Oil Co. 5's of 1930, dated 1910, provided for a payment in 1910 equal to $\frac{1}{20}$ of the outstanding bonds; in 1911, $\frac{1}{19}$; in 1912, $\frac{1}{18}$, and so on.

The Pittsburgh Steel Co. 6's of 1948 require the payment of a sinking fund for the $11,000,000 bonds issued in 1928 in the sum of $500,000 annually, payable $250,000 semi-annually. In case bonds in excess of $11,000,000 are issued later, the sinking fund payments will be increased $250,000 per annum, payable semiannually beginning on the sinking fund date next occurring one and a half years after the issuance of the additional bonds.

4. *Sinking fund installments, part fixed and part based on earnings.*—The following is an abstract made by the Standard Statistics Co. of the sinking fund provisions of the First Mortgage 6's of 1922, dated 1912, of The Locomobile Co. of America.

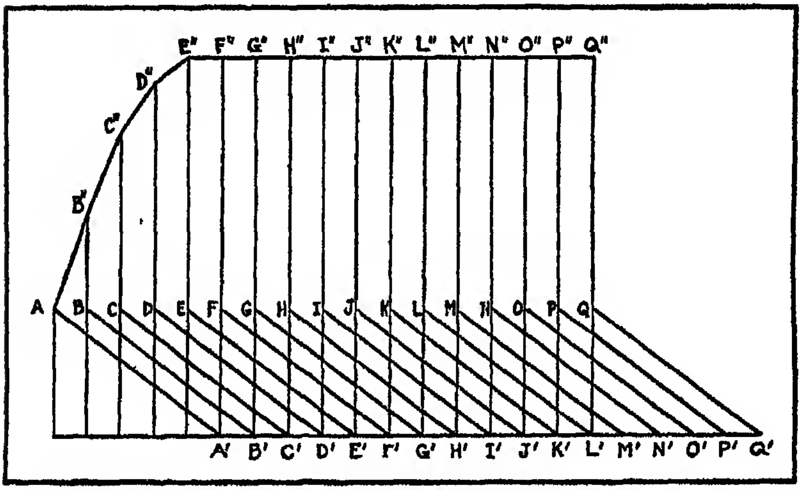
A sinking fund of $150,000 per annum became operative June 1, 1913 Of this amount, $100,000 is obligatory and must be paid to the Trustee The remaining $50,000, or any part thereof, is only to be paid if earned If any part of the remaining $50,000 is not earned and paid during any one year, the unearned balance shall be added to the sinking fund of the following year, or years, to be paid as earned. If, after providing for interest and sinking fund on the First Mortgage 6% bonds, interest on the 6% Debenture Bonds and 7% dividends on the preferred stock, any dividends are paid on any class of stock other than the $1,500,000 preferred, the Company shall pay an amount equal to one-half of such dividends to the Trustee, the money to be used to create a reserve fund of $250,000, and to maintain the same as provided in the mortgage After the reserve fund has been provided for, an amount equal to one-half of any dividends paid on any class of stock other than the $1,500,000 preferred stock shall be paid to the Trustee, and used as a further sinking fund for the purchase of First Mortgage 6% bonds, or for new property or improvements of a permanent nature The reserve fund will be available to meet interest and sinking fund payments under the mortgage, if by any possible chance current earnings should be at any time insufficient, but shall not be used for any other purpose without the consent of the bankers The money in the reserve fund is to be invested in accordance with the carefully guarded restrictions of the mortgage Bonds may be purchased for account of the sinking fund by advertising for tenders at not over 105 and interest, but if not obtainable at 105 and interest or less, shall be drawn by lot All bonds acquired by the Sinking Fund are to be cancelled forthwith

The Hoberg Paper Mills, Inc. First Convertible 5's, due 1946, have a sinking fund requirement calling for an annual payment equal to $25,000 plus 8 per cent of net earnings for the preceding calendar year.

In some indentures the obligatory minimum payment is designated as a fixed sinking fund, and the payment based on earnings is called a contingent sinking fund or an earnings sinking fund. The indenture covering the Firestone Tire & Rubber Company Ten-Year 3½ per cent debentures, due 1948, provides for a fixed minimum sinking fund to retire $1,500,000 principal amount of debentures annually. The indenture also provides for an additional earnings sinking fund to retire annually either $1,200,000 principal amount of debentures or such lesser amount as may be retired through the application of a sum equivalent to 20 per cent of the con-

solidated net income for the preceding fiscal year. To the extent that retirements through the additional earnings sinking fund are less than $1,200,000 in any year, such deficiency is to accumulate and is payable in subsequent years The additional earnings sinking fund may be credited with debentures redeemed other than through the sinking funds.

5. *Series of bonds* —Very often bonds are issued in groups at different times to provide means for financing recurring demands Take the purchase of railway equipment as an example. Serial bonds are used for this purpose, but a railway will at one time have a number of series outstanding, each



How Consecutively Issued Serial Bonds, Each Involving a Decreasing Annual Burden, Involve a Uniform Annual Burden When Taken Together

usually numbered with a letter of the alphabet. Thus, at the time of this writing, Southern Railway Co. has outstanding equipment obligations lettered "Y," "Z," "AA," "BB," "CC," and "EE." In cases of this kind, a fixed number of bonds may be retired annually, either by operation of the sinking fund or by virtue of serial maturities, without placing an unduly heavy burden on the first years. The reason for this condition is that as bonds are retired and the burden of interest decreases on one issue, a new issue is brought out in which the interest burden is at a maximum. The above diagram illustrates the situation. The oblique lines AA', BB', and so on, represent the declining annual burden of serial bonds. The increasing distances from the base line

to the line $AB''C''D''E'' \ldots Q''$ represent the increasing burdens of successive issues The horizontal line $E''Q''$ shows how the annual burden of successive issues remains constant though the burden of each issue declines. The diagram will be better understood if it is appreciated that on the vertical line BB'', the distance between B and B'' is equal to the distance between the base line and the point where the line AA' crosses the vertical line BB''; on the vertical line EE'', the distance between E and E'' is equal to the sum of the distances between the base line and each of the points of intersection of the oblique lines AA', BB', CC', and DD' with the vertical line $EE.''$

6 *Sinking fund installments proportioned to number of bonds issued under present and prior mortgages.*—A provision that bases sinking fund payments on the number of bonds outstanding under the present and prior mortgages gives effect to the consideration that a bond is strengthened by decreasing the indebtedness that has a claim prior to it or along with it. Thus the Puget Sound Power & Light 5½'s of 1949, secured by an unlimited open-end mortgage, provide a sinking fund of 1¼ per cent per annum of all bonds under the mortgage and all underlying bonds outstanding. The Montana Power Co. had a somewhat similar but more complicated provision in its mortgage securing the First and Refunding 5's of July 1, 1943. The calculation was made not only on underlying bonds of the parent company but on bonds of the subsidiary company as well.

7. *Sinking fund installments variable with earnings but with fixed minimum.*—Bonds that have sinking fund payments that vary for one reason or another, with a fixed minimum, recognize two principles: (1) that the term of the bond is fixed and if the indebtedness is to be made up out of earnings during the life of the bond, each year will have to bear some burden; and (2) even if the company has no earnings, the passage of time is bound to tend to reduce by depreciation the value of the equity behind the bonds. Indeed, an abandoned property may and usually does deteriorate more rapidly than a used property, and it is wise, therefore, to require some payment that may induce continuous operation. The Creameries of America, Inc, Debenture 5's, due 1946, have a sinking fund calling for the payment semiannually of 5 per cent of consolidated net earnings for the preceding fiscal year, or the sum

of $25,000, whichever is greater. In the First Gold 5's, Series A, 1962, of the Hudson Coal Co., the sinking fund is based on the amount of produce exploited, but an annual minimum is set.

8. *Sinking fund installments varying with profits*.—Sometimes this arrangement is fairly simple. The Central Foundry Co. 5-year First Mortgage Convertible 6's due 1941 call for annual sinking fund payments equal to 25 per cent of net income for the preceding year. The San Francisco & San Joaquin Valley Ry. Co. First Mortgage 5's of 1940, dated 1896, are protected by a sinking fund into which a percentage of net profits is required to be placed as follows 1916 to 1920, 1 per cent; 2 per cent to 1925, 3 per cent to 1930, 4 per cent to 1935, and 5 per cent thereafter to maturity The sinking fund requirements of the First Gold 3½'s of the New York, Chicago & St. Louis R. R call for a payment of $100,000 when net earnings exceed $900,000.

Champion Paper & Fibre Co. debenture 4¾'s, due 1950, call for retirement of $165,000 of debentures if consolidated net earnings applicable to dividends for the next preceding fiscal year have amounted to less than $1,300,000; $220,000, if such earnings have amounted to $1,300,000 but less than $1,600,000; and $275,000, if such earnings have amounted to $1,600,000 or more.

9. *Sinking fund installments varying with amount of depletion.*—Where a bond issue is secured by what are termed wasting assets—that is, assets such as mineral ores, oil, and timber, which cannot be replaced in kind and place—it is natural to regard the sinking fund as the equivalent of the material that has been used up to earn the company's income.[18] It would appear, therefore, that the increase in the sinking fund should bear some relation to the rate of depletion—that is, the rate at which the material is used up. The Carlisle Lumber Co. First Gold 6's, due 1945, call for the payment into a sinking fund of $2 for yellow fir, $2 for red, $1 for white, 50 cents for cedar, and $1, for hemlock, per 1,000 feet of timber cut. The sinking fund of the Lehigh Valley Coal Co. First and Refunding Gold 5's, due 1974, varies with the amount of depletion, but has a fixed annual minimum

[18] As was pointed out above, sinking funds used for protection against wasting assets are called amortization funds. Sometimes a corporate charter will provide that they shall be used to protect stock as well as bonds

payment. Thus, annually 5 cents per gross ton of anthracite of all sizes mined from land owned, operated or leased by the company, and sold commercially or used, but not less than $250,000, must be set aside for redemption of bonds.

10. *Sinking fund installments varying with amount of business*—Where, as was pointed out in an earlier paragraph, the sinking fund payments are proportioned to the surplus earnings of the company, there is some relation between the size of the payments and the ability of the company to pay them. Especially is this true where the sinking fund is, as we shall point out in the next section, dependent for the rapidity of its growth on the surplus earnings available after the payment of dividends. The more the company earns, the more it can appropriate for the retirement of bonded indebtedness. But what is to be said in favor of sinking fund provisions which provide that the payments shall be proportioned to gross income? The Ontario Power Co. of Niagara Falls 6's of 1921, for example, were protected by a sinking fund which required 25 cents to be set aside for each unit of electric horse power sold and paid for during the preceding calendar year. The United Fuel Gas Co. Series "A" 6's of 1936 were protected by a sinking fund into which was to be paid 1¼ cents for each 1000 cubic feet of gas produced and sold during the preceding year.[14] Sinking fund provisions such as these simply force a company to efficiency in production. Where the period of the bond is very long, and consequently the amount to be placed in the sinking fund each year is very small, no harm will be done by such a requirement. But we saw during the period of rising prices following the World War how dangerous it is to load public utilities with burdens when gross income is quite certain to be stable and operating expenses likely to increase very rapidly.[15]

Related to sinking fund installments varying with the amount of business or with profits are installments varying with the price of commodities handled by the company.

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[14] True, the mortgage set this rate, but also provided that the company need not pay at a greater rate than was required to meet the principal indebtedness at maturity

[15] From the standpoint of the public, where rates are being set by a regulating commission at a point where they will be as low as possible and still yield sufficient to defray expenses and leave a fair return for stockholders, the sinking fund should hardly be permitted to grow more rapidly than the property which was procured by the bond issue wears out

The Cuban Dominican Sugar Co. had a sinking fund of \$100,000 annually, beginning December 31, 1931, for its First Lien Gold 7½'s, due 1944, provided the average net price per pound of sugar for the preceding crop season equalled 2½ cents; for any higher average net price for sugar up to 5 cents and over, varying additional amounts up to \$1,000,000 were to be added to the sinking fund in accordance with a schedule specified in the agreement. The sinking fund provision also stated that if production were less than 2,250,000 bags annually, one-half the amount as scheduled was to be paid, and if less than 2,000,000 bags were produced, no payment was to be made.[16]

11. *Sinking fund conditioned on payment of dividends*— Sometimes the sinking fund payment is either permitted to lapse entirely or to vary, if dividends are not paid on the stock of the company. Thus, the mortgage securing the City & Suburban Railway First Gold 5's, due 1948, provides for sinking fund payments of \$25,000 per annum after payment of dividends of 6 per cent per annum on the capital stock Since the company never paid the dividends mentioned, no payment has ever been paid to the sinking fund.

Frequently, some provision is made for a stipulated sinking fund installment and a further payment is provided contingent on dividends. Thus, in the case of the Adjustment Debentures of the Chicago Rapid Transit Co., if the company in any fiscal year pays a dividend of more than \$834,000 on any class of stock not entitled to preference, payments to the sinking fund in addition to the regular requirement must be made in an amount equal to 30 per cent of such dividend payments.

The sinking fund provision of the deed of trust which secured the First Mortgage 6's of 1936 of the Southern Sierras Power Co , dated 1911, read in effect that, beginning January 1, 1917, 20 per cent of the net earnings, after the deduction of fixed charges, must be set aside as a sinking fund to be applied to the purchase or redemption of these bonds at not over 105 with interest. The deed of trust further provided that the

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[16] In a refinancing plan announced in August, 1929, this provision was substituted for the original plan, which called for fixed semiannual payments and additional payments equivalent to 25 per cent of all dividends declared and paid on the company's common and preferred stock. The corporation was reorganized in 1932 as West Indies Sugar Corp.

company should not pay dividends on its capital stock in excess of 6 per cent per annum, unless at the same time it deposited with the trustee for the sinking fund a sum equal to the aggregate amount of any dividend so declared and paid in excess of 6 per cent, said payment into the sinking fund to be concurrent with the payment of said dividend.[17]

12. *Installments conditioned by current financial position* — Some sinking fund provisions seek to protect the corporation against the necessity for making payments while the company's working capital is weakened. Thus, each sinking fund payment of the Hoberg Paper Mills, Inc. Convertible 5's of 1946 is reduced in amount or waived to the extent that it would, as of the close of the preceding calendar year, reduce the working capital of the company below $450,000.

13. *Sinking fund built up from proceeds of sale of released properties.*—Almost all corporate mortgages contain clauses providing for the sale of unnecessary property free from the lien of the mortgage.[18] The proceeds are usually to be invested in other property that will be covered by the mortgage, or are to be given to the trustee to be invested as a sinking fund. Such sinking fund provisions are usually applied to the proceeds from the sale of so-called land-grant properties of the older railroads, that is, properties which were given by the State or by the United States as subsidies to help build the railroads An example will be found in the First Mortgage 4's of 1949 of the Wisconsin Central Ry. Co. In 1918 the General Petroleum Corporation retired $900,000 of its 6 per cent bonds, the entire amount then outstanding, by the sale of lands to the Standard Oil Company.

14 *Payments from exercise of stock purchase warrants.*—With the use of the stock purchase warrant in connection with the sale of bonds, another method of building up sinking funds has come into existence. We have seen in Chapter VIII that in order to check the increase in capitalization which would arise upon the exercise of stock purchase warrants, some corporations provide that the funds received upon exercise of the privilege shall be used for redemption purposes. The transfer of such funds to a sinking fund

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[17] Standard Statistics Company's bond card

[18] See C. W. Gerstenberg, "Materials of Corporation Finance," pages 236–239.

accomplishes this result if the sinking fund is invested in securities of the corporation. The Consolidated Gas Utilities Co. First Collateral Gold 6's, Series "A," of 1943, provide that all moneys received from the exercise of stock purchase warrants which were issued with the 6½ per cent Convertible Gold Debentures, Series "A," shall be paid into the sinking fund. The Larutan Gas Corp. applies 50 per cent of the proceeds received from the exercise of the stock purchase privilege, which accompanied the Sinking Fund Gold 6½'s, to the sinking fund protecting those bonds.

15 *Optional sinking funds.*—Rarely is the amount to be placed in the sinking fund left to the discretion of the company Such a sinking fund is of doubtful value to the bondholders, since when it is most needed it is least likely to be built up.

Modern large limited open-end mortgages, as, for example, the mortgage of the Pennsylvania R. R. Co., dated June 1, 1915, which provide for issues of bonds in "series," each series to be varied as to interest, maturity, and the like by the directors at the time of issue, usually provide that any one or more series may be issued with or without a sinking fund. Such a contract should be clearly distinguished from the optional sinking fund, for in the latter the directors may, after the bonds have been sold, elect in any year to pay or not to pay a sum into the sinking fund, while in the former contract the election to pay continuously or not to pay at all is made before the bonds are issued.

16. *Cumulative and non-cumulative sinking funds.*—Very frequently the sinking fund will fail to grow from year to year because of a provision inserted in the mortgage providing that if the fund cannot be invested in bonds of the same issue at or below a certain price, the fund shall lapse or revert to the company. The Delaware River R. R. & Bridge Co. 3½'s of 1946 are an example of this kind of sinking fund.

Here the option to pay or not to pay is dependent not on the company's ability to meet the sinking fund installments, but on the possibility of finding the right kind of investment. There are mortgages, however, which provide that the payment need not be made in bad years but must then be accumulated and made up in good years. For example, the Chicago, Milwaukee & St. Paul R. R Co. Convertible Adjustment 5's, due 2000, provide that if the full payment of ½ of 1 per cent

of the authorized principal amount of adjustment bonds is not made, the deficiency shall accumulate.

The sinking fund of 1 per cent per annum to retire Series "A," First Gold 5½'s of the Cincinnati Street Ry. Co., dated 1927 and due 1952, is cumulative. The sinking fund provision further requires that in 1940, if the franchise has not been extended to 1960, the company must, for so long as such extension is not made, increase sinking fund payments sufficiently to retire all Series "A" bonds by the time of expiration of the franchise or maturity of the bonds, whichever is earlier.

17. *Special funds for interest.*—It may seem illogical to borrow money and then "post," or deposit, part of it to secure the payment of interest on the entire loan. Still that is just what is sometimes done. The Jamison Coal & Coke Co., for example, in 1912 issued $5,000,000 of 5 per cent bonds due in 1931, with a provision for a sinking fund of $300,000 a year. The company was required, by the terms of the mortgage, to deposit $200,000, and to add to this sum $25,000 a year till $500,000 was made up. This fund held by the trustee was to be used to pay interest or sinking fund requirements if in any year the earnings were insufficient to do so. If amounts were drawn from the fund for either of these purposes, they were required to be replaced out of earnings in future years. The result was a fund somewhat similar in purpose and organization to the "surplus capital reserve account" of protected preferred stock.[19]

Anticipating sinking fund provisions.—Frequently, when companies that have determined to eliminate bonded indebtedness have years of exceptional prosperity, they anticipate the requirements of their sinking funds by one or more years. A provision in the deed of trust of the Remington Rand, Inc. Debenture 4¼'s, due 1956, permits the company to increase any sinking fund payments and receive credit therefor in subsequent years. In 1917 the Booth Fisheries Co. antici-

[19] The provision as to the accumulation of a fund out of earnings seems defensible, since the stockholders are asked to forego their profits to insure prompt payment of the company's obligation To be sure, from the stockholders' and corporation's viewpoint, the fund ought to draw interest equal to or greater than the interest being paid on the bonds But the payment down of the original $200,000 seems poor policy If the company cannot use that to very good purpose, it ought not to have been borrowed If it can be used, why handicap the company?

pated three years' requirements. The same practice, it was reported, was followed by the American Can Company in the years of war prosperity. The tangible evidence of the company's prosperity that this procedure gives is likely to be reflected in the market standing of its securities.

Offsets to sinking fund requirements.—Since outstanding bonds enjoy an improved position whenever the indebtedness that has a prior lien or an equal lien is reduced, such a reduction theoretically is the equivalent of a sinking fund for the junior or co-ordinate issue. For example, if issue "A" for \$1,000,000 has a first lien on the property, and issue "B" for \$2,000,000 has a second lien, as illustrated in the diagram below, "B" would be as much improved by a reduction of "A" through \$250,000 paid out of earnings as it would be by

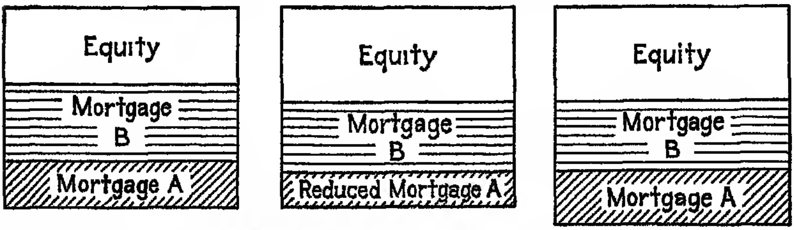

Diagram Showing How Aggregate Equity Is Increased to the Same Extent by Using Sinking Fund to Retire Earlier Mortgage as by Investing Sinking Fund in Additional Property

adding to the equity \$250,000 out of earnings. (See, however, the further discussion and diagram on page 302.)

Hence, deeds of trust frequently provide that payments into the sinking funds of prior mortgages are to be deducted from amounts required to be paid into the sinking fund of the mortgage in question, until the prior lien is extinguished. Such a provision is contained in the deed of trust covering the Remington Rand, Inc., Debenture 4¼'s, due 1956.

By somewhat the same process of reasoning, sinking funds should be reduced whenever the bonded indebtedness is reduced. If, for example, the sinking fund requirement for "B" bonds in the above example is \$200,000 a year, and if the bonds are convertible and one-half the bonds are converted into stock, the sinking fund ought to be reduced to \$100,000 a year. The mortgage securing the First Collateral Gold 6's, Series "A," of 1943, of the Consolidated Gas Utilities Co. provides that the proportion of the sinking fund attributed

to the Convertible Debenture Gold 6½'s, Series "A," of 1943, which shall be released by the conversion of any bonds into class "A" stock shall be applied to the sinking fund protecting the First Collateral Gold 6's, Series "A."

Sometimes sinking fund payments are offset by waiving the right to issue an equal amount of bonds for property acquired. Idaho Power Co. First 3¾'s, of 1967, provide that the company will annually deposit cash or bonds equal to 1 per cent of the outstanding bonds or will waive the right to issue an equal principal amount of bonds

Most modern deeds of trust which provide that the sinking fund shall be invested in bonds of the same issue also provide that the company may make its payments into the sinking fund in whole or in part in bonds of the protected issue instead of in cash.

Law of sinking funds.—Sometimes sinking funds are required by statute, usually for railroads or other public utilities, but in most cases sinking funds are established in pursuance to an agreement in the mortgage. The terms of such an agreement should be carefully drawn, especially in regard to the use of accounting terms; to avoid disputes, it should clearly define such terms as "net earnings," "net quick assets," and the like

Where a default is made in respect to the sinking fund, as for example, where a payment is not made to the trustee as required, the mortgage usually provides that the trustee may make a demand on the corporation, which, if not responded to, paves the way for foreclosure proceedings.[19a] If the trustee so desires, instead of foreclosing he may bring an equitable action to compel the company to meet its sinking fund obligation. Such action would be taken, of course, where the default was due not to inability of the corporation to meet its obligation, but to neglect or fraud.

Waivers of sinking fund installments.—If the company cannot make its sinking fund payments, it may seek to get a temporary waiver of the requirements. Thus, in 1930, holders of Independent Brewing Co. of Pittsburgh First Gold 6's, due 1955, agreed to suspend the sinking fund for

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[19a] Under the Trust Indenture Act of 1939, the mortgage must provide that in case of default, as defined in the indenture, the trustee must act as a prudent man would act under the circumstances in the conduct of his own affairs See also footnote 5, page 277, and the explanation of the Act on page 207.

five years, and in 1936, entered into an agreement modifying the sinking fund provisions. The waiver may be secured for some concession made to the bondholders by the stockholders, which concession operates against the latter's interests.[20]

How shall the sinking fund be invested?—The first problem in connection with the sinking fund, we saw, was the method of its creation and growth. We now come to the second main problem, that of its investment. In the first place, it should be said that in some cases the sinking fund is handled by the corporation, and in other cases the payments are made to the trustee who manages the investment. The former method is used chiefly by industrials and public utilities, and the latter by railroads. Sinking funds may be invested in:

1. Government securities or securities of other companies.
2. Securities of the same issue
3. Other securities of the same company.
4. An improvement fund
5. A combination of the above.

Sinking funds may also be left with the trustee to draw interest as a time deposit.

The effect of each of these methods on the company and on the security may be briefly studied.

Cash sinking funds.—A company ought not to store up funds drawing interest at a rate lower than that which it is itself compelled to pay for its borrowings. Hence sinking funds as cash deposited with the trustee are seldom found except where the cash provision is an alternative to some other form of investment which may not be possible at the time. Thus the 5's of 1927 of the Columbia Gas & Electric Co. of West Virginia were protected by a sinking fund consisting of payments which were either to be left at interest with the trustee, used for the redemption of bonds at par, or invested in other securities approved by the trustee.

Sinking fund invested in securities of other companies.—To this method of investing the sinking fund, many objections can be raised. The most obvious is that it entails taking money from the obligor company and turning it over for use to some other enterprise. Then there is always the question: when these securities are to be turned into cash,

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[20] Whether a waiver can be given by the trustee in any given case will depend on the power conferred on the trustee in the deed See footnote 19*a*.

what price will they bring? Indeed, if they are to be kept for a long maturity, many hazards to which the companies whose securities are being held are heir may become real catastrophes, in which event the sinking fund will fall short of meeting the maturing indebtedness. To cope with this latter objection as far as possible, the mortgage usually restricts the investment to those securities which under the savings bank law of the State are legal investments for savings banks and trustees [21] While these securities are more likely than most other securities to be of stable value, many of them will not be "gilt edge" then or even five years after the day they are selected. Moreover, they are in demand to absorb the large funds of insurance companies and savings banks and the interest rates they bear are quite certain to be lower than the interest which the company must pay on its own indebtedness. The Dallas Electric Corporation 5's of 1922 permitted the trustee to invest the sinking fund (if bonds of the same issue could not be obtained at 105 or better) in first mortgage bonds of street railway or electric lighting companies doing business in the United States. Of course, while this wide discretion may be given in the mortgage, the trustee would be required to make a prudent selection and would do well to follow the somewhat well-defined restrictions of the law relating to "legals"[22]

The mortgage securing the 5's of 1943 of the Ontario Power Co of Niagara Falls (of Canada), dated 1903, provides that if bonds of the same issue are not obtainable, the sinking fund shall be invested in British Consols or in United States Government bonds.[23]

Sinking funds invested in bonds of the same issue.—By far the most usual method of investing the sinking fund is in

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[21] See C W Gerstenberg, "Materials of Corporation Finance," pages 447–454, for the law in New York State Many publications have been issued designating the securities available as legal investments in the several States The State and City Section of the *Commercial and Financial Chronicle* publishes this information

[22] See also Northern Pacific General Lien Mortgage Gold 3's, due January 1, 2047 (investment to be made in bonds of same issue or in securities legal under the Savings Bank Law of the State of New York)

[23] The depression in the market value of United States Government bonds and in British Consols which were outstanding from 1903 to 1913 is a good illustration of the fallacy of selecting "Gibraltar" investments for sinking funds.

bonds of the same issue [24] The advantages of the method are first, the sinking fund definitely accomplishes its purpose of extinguishing the bonded indebtedness, second, manipulation which is possible where the sinking fund is to be invested in other corporate enterprises is eliminated, third, the regular investment of the sinking fund provides an artificial demand for the bonds on the market and thus maintains the price The great disadvantage of this method is that it gradually narrows down the market for the bonds and thus makes those that have not been chosen for early redemption somewhat unmarketable. This disadvantage is to some extent offset by the fact that the constant demand for bonds for sinking fund purposes tends to maintain the price of the bonds up to the redemption price.

Usually, the mortgage will provide that the sinking fund shall be invested in bonds of the same issue obtained either by purchase on the open market or by advertisement. If both of these methods fail, the securities are to be drawn by lot.[25] The great advantage of this method of using the sinking fund is that it definitely uses the sinking fund for extinguishing the debt and that the corporation gets about as much for its money as it has had to pay The fact that a company frequently has to pay a premium for its own bonds is a disadvantage, to be sure, but there are many companies which provide for the redemption of bonds at par.[26] Moreover, the premium is to be paid only when the bonds cannot be obtained at a lower price on the market, and when a premium is paid, the company usually has the consolation of knowing that the

[24] A S Dewing gives the following statistical information in his "Financial Policy of Corporations," Third Revised Edition, p 685

The various methods of providing for the investment of sinking funds were found by Kielland to be apportioned as follows

	Railroads	*Public Utilities*	*Industrials*
Require the purchase of bonds of same issue	72%	68%	80%
Permit bonds of different issues of same corporation	9	5	1
Permit outside securities	9	6	4
Permit investment in improvements to property	10	21	2
Not explicit			13

[25] See the Jones & Laughlin mortgage in C. W Gerstenberg, "Materials of Corporation Finance," page 220, and see *ibid*, page 336, for illustrations of advertisement and notice of drawing by lot

[26] The Southwestern Bell Telephone Co First and Refunding 3½'s of 1964 are purchasable at par for sinking purposes, but redeemable otherwise at 107½ to 1945, 105 to 1950, 102½ to 1960, and then at par.

premium and the payment thereof are the effect and partially the cause of its good credit standing.

Even where the right is given to purchase bonds on the open market, it is advisable to permit the company to call for bonds by advertisement. If the company goes on the market, its bids for bonds will be the signal for an upward turn, but if it calls for bonds by advertisement, the market price may remain stable and bonds may be offered at a fraction of 1 per cent above the market price. Thus all the bonds that are needed may be acquired at 100¼, while by going on the market, the bonds may be obtained at prices ranging from 100 to 105, with an average of 102½.

Canceling or keeping alive.—After the bonds are obtained by the trustee, they may either be canceled or kept alive. If they are canceled, the company saves future interest payments; if they are kept alive, the company continues to pay interest on them, which interest, of course, goes into the sinking fund and thus accelerates its growth. Many examples of either method of handling the bonds can be found.[27]

Registered bonds to be drawn after coupon bonds.—When an option is given to the bondholder to take his bond either in registered or coupon form, the one who takes the registered form is likely to be an investor who wants to put his bond away in a safe deposit vault with the feeling that his money is securely and safely invested To meet his wishes, mortgages sometimes provide that where bonds are to be drawn for the sinking fund, no registered bonds shall be called until the coupon bonds have been paid. Such a provision, for example, was contained in the deed of trust securing the ten-year collateral 6's of 1918 of the United States Rubber Company.

Price at which bonds are to be bought.—The price at which bonds are to be bought or drawn is usually stated. This may run, as has already been indicated, from par to a premium sometimes as high as 110.

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[27] The so-called sinking fund tables are built upon the principle that the sinking fund is invested in bonds of the issue and that they are kept alive These tables tell how much is necessary to be set aside periodically with interest to yield one dollar at the end of any number of periods See C E Sprague, "Accountancy of Investment," and for an example taken from this book, see C W Gerstenberg, "Materials of Corporation Finance," page 1024 See also *ibid*, page 1023, for a calculation taken from H Lyon, "Capitalization," page 163

The First Mortgage 5% Gold Bonds, Series A, of American Smelting and Refining Company call for a sinking fund of 1½ per cent of the outstanding bonds for purchase of bonds at prices not exceeding 105. To the extent to which purchases of bonds cannot be made at or below this price, the unapplied moneys in the sinking fund at the end of each year are credited to the company on the next year's sinking fund installment Sometimes, instead of naming a price that will hold irrespective of the relation of the redemption date to maturity, the more scientific method is used of providing that the bond shall be purchased to yield a certain per cent, usually 1 per cent below the nominal rate of the bond. Thus the ten-year 7's of 1929 of the Anaconda Copper Mining Co. were protected by a sinking fund which provided for investment in the bonds to yield not more than 6 per cent. The price at which the bonds can be bought may be left by the mortgage to the future decision of the company and the trustee. For example, the mortgage of the Bay Counties Power Co. securing its 5's of 1930 provided that the sinking fund should be used to redeem bonds at a price to yield not more than 4 per cent or at such higher price as the company and the trustee might agree upon Since the use of the sinking fund to purchase bonds at varying premiums may result in the calculations going somewhat awry—that is, the sinking fund may have been calculated to meet the indebtedness at par—the mortgage may provide, as it does in the case of the Salmon River Power Co 5's of 1952, that if bonds are purchased at a premium, the sinking fund shall be increased to the aggregate amount of such premium.

Sinking funds invested in securities of the same company.—Since the retirement of a prior lien helps the security of the bonds, a sinking fund may very well be invested in bonds of the same company, provided, of course, they enjoy a prior lien One great disadvantage of the investment of the sinking fund in bonds of the same issue is that as the bonds are retired, the market narrows for those bonds which remain outstanding and they lose that essential quality of an investment security, marketability. To avoid this difficulty, modern mortgages, especially in the case of railroads and public utilities, provide that the investment may be made in bonds secured by a prior mortgage. Thus, the mortgage securing the 5's of 1962 of the International Railway Co.

provides that the sinking fund shall be applied to the extinction of prior lien indebtedness.[28] There would be no advantage in the investment of the sinking fund in subsequent liens.

Investment of sinking fund in improvements.—Sometimes it is provided that the sinking fund shall be invested in improvements in the company.[29] This is tantamount to saying there shall be no fund at all, for a fund is a definitely ascertainable asset easily convertible into cash for a definite

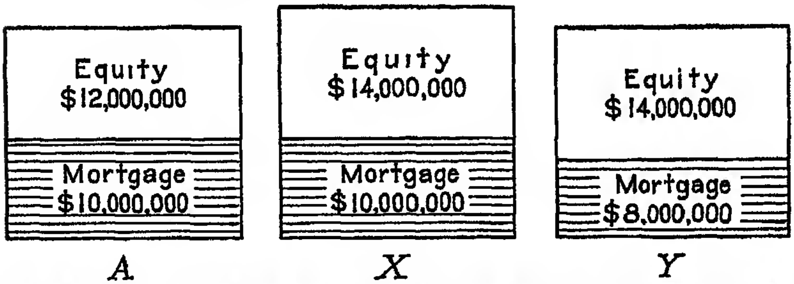

Diagram to Show That the Security Behind Each Bond Is Greater When Sinking Fund Is Invested in Bonds of the Same Issue Than When It Is Invested in Additional Property

purpose. What this so-called sinking fund really does is to increase the equity behind the bonds. Nor must it be believed that this has the same effect on the bonds as an equal reduction of the bonded indebtedness. If company *A* in the above diagram has a mortgage of $10,000,000 on a $22,000,000 property and sets up a sinking fund of $2,000,000 out of earnings, the effect may be as in case *X*, where the fund is invested in improvements, or as in *Y*, where it is invested in bonds of the issue. In *A*, each $1,000 bond is protected by $2,200 of property, in *X* (improvement fund method), by $2,400 of property; but in *Y* (sinking funds invested in bonds of same issue), by $2,750 of property.

For this reason, the method of investing the sinking fund in improvements is generally used only as an alternative to some other method, in cases where the other method cannot be followed For example, it may be provided, as in the case of the Duluth Superior Transit Co. First 5's, due 1953, that part of the fund, in this case one-half, may be used for addi-

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[28] For discussion of effect of conversion in narrowing the market, see page 255

[29] A fund of this kind is sometimes called a maintenance fund.

tions and betterments to the property, but that the rest must be used to redeem bonds of the same issue.[30]

Sometimes the mortgage provides an improvement fund either in addition to the sinking fund or as a substitute for it. This fund is for the purpose of insuring the sustained value of the property securing the bonds. The New York Steam Corporation First Gold 6's, Series "A," due 1947, are protected by a sinking fund as well as by an improvement fund. The provisions of the mortgage of the Montana Power Co. securing the First and Refunding 3¾'s series, due 1966, are interesting, and their operation is described by Moody's "Manual of Investments" as follows:

So long as any of the 1966 series bonds are outstanding, the company will, on or before Jan 1 of each year beginning 1938, deliver to Trustee (a) an amount in cash (or, in lieu thereof, 1966 series bonds at the principal amount thereof) equal to 1 per cent of the greatest principal amount of 1966 series bonds theretofore outstanding and (b) an amount in cash (or, in lieu thereof, bonds of any series at principal amount thereof) equal to ½ of 1 per cent of the greatest principal amount of 1966 bonds theretofore outstanding, provided, however, that there shall be credited against cash payable under (b) above (1) the cost or then fair value, whichever shall be less, of property additions or subsidiary property additions, (2) cost or fair value, whichever is less, of any property additions or subsidiary additions which at any time shall have been made the basis of the withdrawal of cash and which the company shall elect to make the basis of a credit against sinking fund payments; (3) aggregate principal amount of bonds which the company is then entitled to have delivered under any of the provisions hereof, and (4) the amount of cash withdrawn as provided All cash deposited pursuant to (a) above is to be applied to the purchase of series 1966 bonds at not exceeding redemption price thereof Any cash deposited pursuant to (b) above may be withdrawn, used or applied as provided

Taxability of profit made by repurchase of bonds.—We have indicated that corporations sometimes purchase bonds in the open market to meet sinking fund requirements. We have also shown[31] that corporations sometimes purchase their

[30] Many companies provide that the improvement method shall be used where the bond investment method cannot be used because no bonds are available. In such cases the company does not believe it expedient to provide for the redemption of the bonds by lot But in a number of cases the improvement method is open to the company as an alternative that may be selected in preference to other methods of investing the sinking fund See the 5's of 1943 of the Indiana Railways & Light Company. In this connection, the sinking fund provisions of the 5's of 1951 of the Denver Gas & Electric Light Company are interesting, since besides being somewhat complex they obviate some of the objections to the improvement fund method of investment—in that the sinking fund when invested in bonds grows at the rate of 1 per cent of the outstanding bonds per year, whereas when the investment is made in improvements, the rate is 2 per cent.

[31] See page 268.

own bonds with cash available for investment purposes and redeem the bonds acquired before maturity. Where a corporation has issued its bonds at a certain price and has paid less than that price for them in a subsequent repurchase, the difference between the issuance price and the repurchase price is income taxable under the Federal income tax law, unless the corporation establishes that it was in unsound financial condition at the time of the repurchase.[32]

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[32] U S v Kirby Lumber Co , decided by the Supreme Court of the United States, November 2, 1931 The exception noted for corporations in unsound financial condition was added to the Internal Revenue Code by the Revenue Act of 1939 and applies to any security issued by any such corporation in existence on June 1, 1939 The provision does not apply to any repurchase occurring before June 29, 1939, or in a taxable year beginning after Dec 31, 1942

Chapter XVIII

CAPITALIZATION

Original style of capitalization.—Partnerships and individual proprietorships do not have the problem of capitalization which arises in forms of organization issuing shares of ownership. Corporations, business trusts, and joint stock companies have the problem in very complicated form. Not only is there the question of the original amount of capitalization, but there is also the question of the kind of capitalization; then, too, as the company grows and needs more capital, this question is constantly before the managers: what form and what amount of securities shall be issued to those people from whom the new capital is obtained?

When a new business is being organized, bonds ordinarily will not be used, though in the case of public utility companies and railways, in which large sums are used to acquire tangible property future earnings of which can be quite accurately foretold, bonds may be used in order to minimize annual charges. Purchasers of bonds buy safety and forego the expectation of large income. Bonds should never be used unless estimated earnings will give a factor of safety of at least 100 per cent; moreover, where bonds are used, the estimates of capital needed and the amount of funds actually raised should include a liberal amount to pay interest on the bonds during the period of construction. While industrial and mercantile companies should not undertake at the outset the burden of fixed charges, relatively small concerns usually reduce the amount of funds required from the general public by acquiring tangible properties subject to ordinary real estate mortgages.

If a new concern is to finance itself principally through the issue of stock, various forms of stock may be used to represent the different interests of the owners. The promoters will generally take the common stock, representing, as it were, the residual claim on earnings. The promoters show their faith by standing back in this way, and if the enterprise becomes very profitable, their foresight and faith will reap the reward they deserve. To outsiders, preferred stock may be offered.

If the promoters wish to keep control, they may make the preferred non-voting. If, to make the preferred stock attractive, the holders are given the right to participate in the earnings,[1] the redemption feature may also be included to rid the company of the preferred stock when earnings become large and stable. To make the preferred salable to those who insist upon some assurance of income, such features as the protection fund and cumulation of arrearages may be added. If earning capacity is doubtful, these contingent charges should not be included in the agreement made with the preferred stockholder, for while the right to cumulative dividends, for example, seems a very innocent provision, large accumulations of arrearages may become troublesome. If market conditions require the inclusion of speculative features in senior issues, the preferred stock or bond may be made convertible, or be issued with common stock purchase warrants.

Selection of securities to vary control, income, and risk.— In describing the different forms of securities in preceding chapters, we pointed out their attributes and the circumstances under which securities with such attributes should be used. Here we may review briefly the principal forms of securities, arranging them as they serve the purpose of varying the control, the income, and the risk of the security holders. With such a catalogue of securities as this before him, the promoter of a new enterprise and the director of an expanding old enterprise should be able to make intelligent selection under varying circumstances.

I. Securities arranged in order as they restrict the right of control.

1. Non-voting stocks.
2. Bonds (their holders have the ultimate control of foreclosure).
3. Preferred stock and income bonds that are to vote if holders do not receive income.
4. Bonds convertible into stock.
5. Vetoing stocks.
6. Voting stocks.

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[1] See page 572 for participation in earnings by way of an option to take dividends in cash or common stock, as a feature to make preferred stock attractive

II. Securities arranged in the order of potential claims to increasing amount of income.

1. Non-participating preferred stock.
2. Income bonds.
3. Ordinary bonds.
4. Bonds convertible into stock.
5. Profit-sharing or participating bonds.
6. Common stock.
7. Participating preferred stock.[2]

III. Securities arranged in the order of safety of principal.

1. Stocks not preferred as to assets.
2. Stocks preferred as to assets.
3. Sinking fund, redeemable stocks
4. Debenture bonds.
5. Debentures to be protected by future mortgages, if and when executed.
6. Adjustment bonds.[3]
7. Junior mortgages.[4]
8. General refunding mortgages to take up prior liens.
9. Senior mortgages.

Nominal stock capitalization.—When a company is organized, how much stock should be issued? This problem arises in its most complicated form where a company is to take over operating properties, or is to issue its securities for property difficult to appraise, such as a mine or a patent.

For public utilities and railways—companies enjoying monopolies against which the public must be protected by rate-making bodies—the nominal capitalization should equal the actual investment of the stockholders. If a public utility were thus capitalized, rates could be practically regulated by

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[2] The effects of the cumulative feature and of the protective fund should be kept in mind.

[3] Adjustment bonds are usually secured by mortgages containing a "subordination clause," that is, a clause which provides that at any time in the future the company may issue bonds secured by a mortgage whose lien will be superior to that of the adjustment issue.

[4] In placing mortgage bonds an important question is: what property secures them? Legal priority alone does not fix their status as safe or speculative securities. A bond with a sinking fund in addition to a mortgage may be considered safer than one without a sinking fund. So, too, a moderately termed bond may be considered safer than a long term bond, other things being equal, for the company will always have to keep in mind the obligation of redeeming or refunding.

controlling dividends. If rates were so high as to yield more than a reasonable dividend on the stock, the excess could be kept in the company and used to extend the company's property and improve it—all to the advantage of the consuming public. To be sure, if this practice were permitted to be carried too far, one generation of consumers would pay the way for succeeding generations; moreover, the practice would open the way to unprofitable expansions.[5]

Industrial and mercantile concerns should capitalize on a basis of earning power. The most convincing argument, it seems to us, to justify this basis of capitalization, is that it recognizes the fundamental truth that a business is a profit-making entity and that it is worth what it will earn.[6] If stock is issued to an amount in excess of capitalized actual earning power of the company, the company is said to be overcapitalized and the stock is said to be "watered." Thus, if upon organization of the corporation the earnings are over-estimated, or the rate at which the earnings are capitalized is too low, the company will prove to be overcapitalized. For example, suppose it is estimated that the corporation will earn $150,000 annually and that 5 per cent is a fair ratio between the earnings and the cost of the business; the earnings capitalized at 5 per cent will give a capitalization of $3,000,000. The corporation will issue stock in that amount, with par value or without par value, but with a stated value of $3,000,000, for property, cash, or services. The consideration which the company receives for this stock will appear in the balance sheet as the assets of the company If it should develop that the corporation can earn only $100,000 annually, it is immediately evident that there has been an overcapitalization. At 5 per cent, the correct capitalization would be $2,000,000. Moreover, in an abnormally optimistic market, at which time the securities may have been issued, a rate of capitalization as low as 5 per cent may have been sufficient

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[5] The question of valuing the stockholders' investment in public utilities is not touched upon in the text, for the author feels that it is too large to be treated here even in outline See R. H Whitten, "Valuation of Public Service Corporations "

[6] Hartley Withers, in his "Stocks and Shares," repeats the story told by Boswell of Dr Samuel Johnson's statement when asked to give his opinion of the real value of the Thrale brewery. Dr Johnson's answer was, "We are not here to sell a parcel of boilers and vats, but the potentiality of growing rich beyond the dreams of avarice "

to induce investors to buy, whereas when the market bubble bursts, it will likely appear that companies circumstanced such as the one under consideration cannot command capital at less than 8 or 10 per cent. Even if such a company could earn $150,000 annually, its capitalized earnings would warrant an issue of stock of not more than from $1,500,000 to $1,875,000. Whether the overcapitalization arises from overestimating earnings or from capitalizing correctly estimated earnings at a too low rate, the result will be the same. The stockholders will not receive the dividends they have been promised, and the stock, whether it be with par value or without par value, will fall below the purchase price.[7]

The use of stock without par value seems an attempt to solve the problem of watered stock by ignoring it. But the problem cannot be ignored At some place in its records the company must value its assets and also must set up a capital account in which the capitalized value of the assets will appear. This is true because the company must distinguish between its capital and its surplus for the purpose of measuring what is to be available for dividends. It is a fact that when non-par stock is used, stockholders and creditors are not misled by a fictitious statement of value printed on a stock certificate; they are, however, none the less misled if, when they come to analyze what they are about to purchase when they are considering an investment in the company, they find in the balance sheet a capital account which is made up largely of assets that have been written into the books at excessive values.[8]

Disadvantages of undercapitalization.—The disadvantages of overcapitalization are greater than those of undercapitalization, if for no other reason than that undercapitalization may easily be remedied by writing the intangible asset "goodwill" into the balance sheet and distributing the resulting surplus through a stock dividend.[9] A company that is

[7] Overcapitalization of earnings occurred in many cases during the period of prosperity from 1924 to 1929. One of the reasons for this overcapitalization was that great competition among investment houses for issues of successful corporations had caused them to pay too high a price for properties.

[8] See David L. Dodd, "Stock Watering," pages 303 *et seq*

[9] A simple remedy to reduce the price of stock, without changing capitalization, is to split up the shares and reduce the value of each share in accordance with the rate of the split-up This may be done, in the case of par value shares, by reducing the par value and exchanging one share, let us say of $100 par

undercapitalized ought always to follow this practice, for its stock ordinarily will not sell at its full value. Moreover, since the stock will sell well above par, it will be subject to wide fluctuations in value on the market. Because undercapitalization makes a company appear to be making profits at an exceptionally high rate, competition will be encouraged, employees are likely to become disgruntled, customers may seek price reductions, and the public may be induced to invoke the regulatory powers of government. Perhaps it should be said in passing that undercapitalized companies operated at a disadvantage in this country during the years 1917 to 1921, when the Federal excess profits taxes were in force.[10] (Undercapitalization results in a higher excess profits tax under the present law (Internal Revenue Code, Sections 600–604), but in a lower capital stock tax.) See footnote 22 on page 178.

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value, for four shares with a par value of $25 each Or the shares may be changed from par value stock to non-par value stock and a certain number of non-par shares be issued for each share of par value stock In the case of non-par stock, a reduction in market value is accomplished by a split-up or by the declaration of a stock dividend

At the time of the rising security market of 1927, 1928, and 1929, many corporations split their shares in amounts ranging from 2-to-1 as high as 5-to-1 While this move seemed expedient at the moment, later developments showed that the step was not entirely well taken The *Weekly Bulletin* of Ernst & Ernst, for June 23, 1931, contains the following interesting discussion of stock split-ups

> An analysis by Ernst & Ernst of all of the 1297 issues of common and preferred stocks listed on the New York Stock Exchange as of June 2, 1931, shows that 477, or about 37%, had quotations under $15 per share, and that 354, or 27%, were selling under $10 per share These figures suggest the probability that there were many cases where, due to the extreme drop in market prices, shares possessing considerable merit had to be liquidated because of the fear by the owner that his loans would be called or additional collateral required at a time when he could not furnish it Although the policy of the banks has been somewhat modified recently, the general attitude of holders of low-priced securities is one of considerable doubt, due to the fact that somehow or other the low-priced shares may not be considered as good collateral
>
> In addition to the forced selling which is due in part to the present position of the split-up stocks, there is also another question, growing out of the mounting costs of issuing stock certificates, with their signatures, registrations and other formalities Furthermore, taxes in a number of states are levied on the basis of shares issued, and not on market or book values It has been notable over many decades that where forced reorganizations of companies have taken place, the total shares issued have been reduced in more cases than they have been enlarged The payment of dividends and the earnings per share on a reduced number of shares outstanding would reflect larger unit figures, and this might appear more favorable if there were some net profit for the common stock, or more unfavorable if there were a loss for the common
>
> It has been generally understood that where there is a lesser number of shares outstanding for a given corporation, the price fluctuations due to market trading are more rapid, but relatively smaller in relation to the unit value, than where there is a larger number of shares with low unit price The balancing of this situation by establishing the unit value of a corporation's shares at a point where the benefits of wide stock ownership will be retained, and where at the same time the unfavorable features of too low unit values will be removed, is a problem which some corporation and financial executives will be required to study closely in ensuing months

[10] The intention of this tax was to place a burden on war profits Profits above a certain rate on the investment were taxed at rates increasing with the increase of profits. Obviously it was to the advantage of a company

Disadvantages of overcapitalization.—The dangers of overcapitalization have been explained at great length by a number of economic writers.[11] Here we shall merely summarize these alleged dangers.[12]

I. Disadvantages to the corporation:

1. A company whose stock is watered and sells below par will have relatively poor credit standing.

2. Such a company will have difficulty in raising new capital funds. This disadvantage is not so important now that the use of stock without par value is permitted. A new issue of stock without par value has often proved a blessing to a company whose old shares sell below par.

3. Watered stock encourages payment of unearned dividends

4. It also leads to neglect of depreciation and other reserves.

5. As a consequence of all the above faults, unwieldy debts are likely to be incurred.

6 A large capitalization involves payment of a large organization tax; in some States the annual franchise tax is based on the amount of outstanding stock.

II. Disadvantages to the public

1. Overcapitalization tends to raise the price and to reduce the quality of a company's products.

2. Undue pressure may be placed on the operating heads to keep down wages, and the appearance of small profits may give the company an advantage in the settlement of labor disputes.

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to state its invested capital as high as possible in order to minimize the rate of profits To get at the rate of profits it was necessary to fix the investment in accordance with the following definition

"The invested capital of a corporation includes, generally speaking, (a) the cash paid in for stock, (b) the tangible property paid in for stock, (c) the surplus and undivided profits, and (d) the intangible property paid in for stock," with certain adjustments (Internal Revenue Department, Regulations 62, Section 831.) It would seem, therefore, that intangible property, such as patents and goodwill, could not, under the old Excess Profits Tax Acts of 1917, 1918, and 1921, be included in invested capital unless paid for in stock.

[11] See R T Ely, "Outline of Economics"; C R Van Hise, "Concentration and Control"; Jenks and Clark, "The Trust Problem."

[12] We do not wish to imply that these dangers are not real It has seemed more appropriate to the author to let his readers go to sources where the subject is treated more fully than is possible here.

3. The failure of overcapitalized concerns tends to precipitate panics and to injure classes of creditors

4. Overcapitalization diverts funds from legitimate business into the hands of "stock jobbers."

5. It induces stock gambling

6. It creates a bad ethical atmosphere in business.

III. Disadvantages to stockholders:

1. Overcapitalization is usually accompanied by a certain amount of "rigging the market" when securities are first issued, and stockholders must suffer as true values are revealed in proved lack of earning power.[13]

2. Low-valued stocks, such as result from overcapitalization, usually have relatively small value as collateral for loans.

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[13] The Securities Exchange Act of 1934, by its regulation of manipulative devices, has eliminated this disadvantage to a great extent The provisions of the Act dealing with control of manipulation are summarized as follows in the Senate Report on Stock Exchange Practices, 73d Congress, 2d Session, Report No 1455

"The act makes it unlawful for any person to effect any transaction in a registered security which involves no change in beneficial ownership, or to enter an order for the purchase of such security with the knowledge that an order of substantially the same size at substantially the same time and at substantially the same price for the sale thereof has been or will be entered by anyone for the purpose of creating a false or misleading appearance of active trading in the security

"The act likewise makes it unlawful to effect either alone or in concert with others a series of transactions in any registered security, creating actual or apparent active trading in the security or raising or depressing the price thereof, for the purpose of inducing the purchase or sale of the security by others

"Dealers and brokers are forbidden to induce the purchase or sale of a security by false or misleading statements with respect to any material fact or by the circulation or dissemination, in the ordinary course of business, of information to the effect that the price of such security is likely to rise or fall because of market operations designed to raise or depress the price All persons who receive a consideration from a broker and dealer are likewise forbidden to induce the purchase or sale of a security by the circulation or dissemination of information to the effect that the price is likely to rise or fall because of market operations designed to raise or depress the price

"Practices such as pegging, fixing, or stabilizing the price of a security are subjected to regulation by the Commission, which is authorized to prescribe such rules as may be necessary or appropriate to protect investors and the public from the vicious and unsocial aspects of these practices

"In like manner, the Commission has been vested with control over the subject of puts, calls, straddles, or other options or privileges

"Short selling and the employment of stop-loss orders have not been abolished by the act, but have been placed under the supervision of the Commission, which is empowered to promulgate rules and regulations to purge the markets of the abuses connected with these practices

"In order to render effective the prohibitions against manipulation,

3. Stockholders of overcapitalized companies are likely to have to bear the great expense of corporate receiverships and reorganizations.

4. Stockholders who accept the stock may find themselves liable for the difference between the par value of the stock and whatever the courts determine is a fair valuation of the consideration paid therefor.[14]

Is stock-watering ever justified?—Many commentators on corporation finance, especially theoretical economists, overlook the full significance of the distinction between present and prospective earning power as bases for corporate capitalization.

We may assume that *A* owns a mine the value of whose ore, according to reliable geological reports, is $10,000,000, and that the estimated cost of extracting and marketing the ore, with all overhead expenses, is $5,000,000. If *A* turns the mine over to a corporation for all its capital stock, $2,000,000, and then returns $1,000,000 of the stock to the treasury for sale below par, has *A* confessed to overcapitalizing his company by his act of returning one-half the capital stock? His purpose has been to turn his potential "purchasing power" as it existed in the form of unextracted metal, into active purchasing power by giving to others some inducement to supply the funds necessary to begin operations. The people who supply the funds take great risks:[15] first, as to the accuracy of the geological reports; second, as to the possible occurrence of unusual and unforeseen difficulties in operation; and third, as to the continued integrity and ability of the

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violators are not only subject to the penalties prescribed in the act, but are liable in damages to any person who purchases or sells a security at a price which was effected by the violation."

The Act also regulates the market activities of officers, directors, and principal stockholders. See footnote 24, page 49 and page 103

[14] The subject is treated at great length in David L. Dodd's "Stock Watering, the Judicial Valuation of Property for Stock Issue Purposes."

[15] The Securities Act of 1933 does not prohibit stock watering. Its purpose is to require a full disclosure of the essential facts concerning the securities offered, and to prevent fraud and misrepresentation in the sale of securities. The Securities and Exchange Commission has issued stop orders against the sale of stock where conclusions of value reached by experts were challenged because of unsound methods, inadequate investigation, failure to disclose a proper method of valuation, or because the result expressed was inaccurate. The requirements that the registration statement disclose the expert's interest in the issuing company and that the financial statements be certified by an independent public accountant tend also to prevent the fraudulent issue of watered stock.

managers. On this last point it may be observed that the original owners, to turn their property more quickly into active purchasing power, may sell out their holdings to persons of doubtful integrity and ability. A small purchaser of securities ordinarily has no guarantee that the majority interests will not change hands. Hence the risks are great and the person taking the risks will demand an offsetting advantage This he gets in buying the treasury stock much below par. By taking treasury stock below par instead of unissued stock below par, the holder avoids complications with creditors. If the company prospers, the stock will rise in value and the original purchaser will receive the reward of his risk-taking

In the same way stock issued for prospective earning power always affords a method of isolating the speculative element in an enterprise Funds can be more readily raised through such a separation. In the first place, the speculative securities—common stock—may be sold to persons who are ready to assume the risks involved. If the proceeds of these shares go into the company, they form an "equity" behind the non-speculative securities—preferred shares or bonds—and the latter are therefore sold on better terms to the investing public, for the equity provides a sort of guarantee of safety—it "cushions" shrinkage in values due to one cause or another. If the proceeds go to the promoters and bankers, they prevent an equivalent amount from being taken from the proceeds of the sale of securities that are non-speculative in appearance—for the promoter and the banker must get compensation from some source, else they cannot "carry on." Finally, it may be urged that because the control usually rests in the speculative securities the holders of which get the last share in the earnings, the tendency must be to watch operations closely in order that the company may be made to yield the last dollar that will go to the speculative security holders.[16]

[16] The process of squeezing the water out of the United States Steel Corporation, which is a good illustration, is described, as follows, in A Cotter, "Authentic History of the United States Steel Corporation," page 31 "Year by year the directors have voted large sums out of earnings for the building of new plants, the extension of old ones, until approximately $500,000,000 has been expended in this manner, thus providing adequate protection for the common stock and putting the company today beyond reach of criticism on the charge of over-capitalization "

The reader is referred to Hastings Lyon's little book on "Capitalization" for a more extended discussion of the points raised in the last paragraph of this section of the text.

Chapter XIX

EXPANSION

Capitalization of expansion.—Having examined the principles of initial capitalization, we are now ready to study the methods of capitalizing growth To understand those methods we ought first to consider how and why growth takes place in a business concern. Indeed, before we can discuss how expansion can be financed, we ought to examine the question: should the expansion take place at all? These preliminary questions we shall consider in the next few sections.

How growth may take place.—The causes of growth may be listed and briefly described as follows.

1. *Increasing the amount of sales of the same product in the same market.* This may be done by putting on "greater sales pressure." For example, a sales force may be added to a business previously using mail order methods only. Or new sources of outlet may be sought. Instead of selling direct to the consumer, wholesalers, jobbers, and retailers may be enlisted. Or an advertising campaign may be started. Again, the increase may come from such an intangible thing as a change in price policy. In any event, the cause of the increase in sales may be and usually is directly traceable to some expedient that required funds. To the inexperienced, an increase in sales through the efforts of an enlarged sales force paid on a commission basis may seem to be an exception. Anybody who has had any experience with the hiring of salesmen, however, knows that the cost of hiring a salesman is likely to run from $500 to $1,000.

Even where the increase in business is entirely accidental, funds will be necessary to handle the business. New equipment will be needed for manufacturing and distributing, and a larger working capital will be involved. Moreover, it must be remembered that growth is the ordinary rule of life. Any business that is well managed will grow with the normal growth of the country, and funds will be needed from time to

time. The table on page 316 shows the growth of a number of American corporations taken at random.[1]

2. *Expanding the market.*—The expansion we have in mind here is likely to take the form of the establishment of branches. The amount of funds required will depend largely on the relations that are to be maintained between the branch and the home organization The possibilities involved are described in books on marketing. If the branch is not in fact to be owned, but is to be a mere agency, funds may still be needed to aid the agency or to stock it with products.

3. *Increasing the number of products.*—Experience shows that in marketing new products old concerns enjoy certain advantages and suffer certain disadvantages. They have the advantage of experience and should not make mistakes. They also have the advantage of elasticity. To a certain extent, new products can be added without disproportionately increasing the expenses in every department. On the other hand, frequently the new product is "everybody's business, and nobody's business," and because funds for expansion in this case come, as in most other cases, from the profits of the business, these funds so easily obtained are used carelessly.

The amount of funds needed for a new product, it also should be said, is often affected by the fact that the introduction of a new product is accompanied by the elimination of other, non-profitable products. While immediate funds may be needed, ultimately the amount of regular working capital required may be decreased.

4. *Integration.*—We pointed out earlier that frequently new concerns sell their products and let others make them.[2] The time may come when the concern will desire to manufacture its own product. Or it may wish to make not only the product, but the component parts of the product. Or it may wish to carry on its processes a step further. These two latter forms of expansion are known as integration. A leather concern that started out to buy timber lands in order to get its own tanning bark instead of buying tanning fluid, would be an example of the first form of integration. A printing house that added a bindery to its printing establishment would be an

[1] See "The Large Corporation in American Economic Life," by Gardiner C Means, in the *American Economic Review*, March, 1931, for an analysis of the asset method of measuring growth of corporations.

[2] See pages 7–8.

TABLE No 6
GROWTH OF CORPORATIONS SHOWN BY TOTAL ASSETS IN SUCCESSIVE YEARS
(000 OMITTED)

Company and Year of Organization	*In Year of Organization*	1914	1919	1924	1929	1930	1934	1935	1936	1937
United States Steel Corp (1901)	$1,647,443	$1,792,233	$2,365,882	$2,414,194	$2,286,183	$2,394,544	$2,084,112	$1,822,401	$1,863,976	$1,918,729
Bethlehem Steel Corp (1904)	43,858	106,378	357,236	617,622	801,631	719,760	639,429	673,074	676,060	715,809
General Electric Co. (1892)	50,935	138,418	276,741	381,978	491,657	493,971	381,575	403,434	372,482	383,189
Westinghouse Electric & Mfg Co (1872)	12,529[a]	82,672	184,893	231,430	253,928	246,152	186,069	194,480	203,735	227,455
American Locomotive Co (1901)	57,209	73,425	93,176	89,362	106,241	102,408	55,191	54,249	56,320	61,750
Baldwin Locomotive Works (1911)	53,865	55,003	64,989	80,554	98,855	100,151	70,589	69,673	72,133	66,546
General Motors Corp (1916)	80,897	.	446,653	592,570	1,324,889	1,315,813	1,268,532	1,414,266	1,518,188	1,566,673
Eastman Kodak Co. (1901)	25,359	42,040	88,718	113,428	163,467	167,135	165,630	168,347	170,743	179,387

[a] This is the figure reported for 1892

example of the second class. In either case, integration is likely to involve the form of expansion listed above as No. 3. For example, we have been told of a large printing house that started its own paper plant and then found that its own printing business could not take the entire product. The company, therefore, had to go out and sell paper, and this involved the raising of funds for the establishment of a marketing department for this part of the business

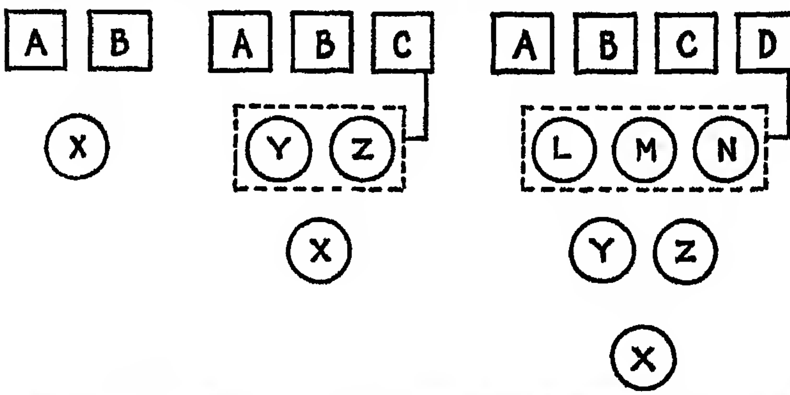
5. *Betterments.*—A form of expansion that may be considered here, although it does not operate to increase sales but to reduce costs, is the substitution of modern machinery for obsolete machinery or for human labor. Assets of this kind are real additions to the wealth of the concern to the extent that they increase the profits of the company. The accounting principle which governs betterments, stated in general terms, is that the cost of the new assets is to be added to the capital of the company to the extent that the cost of the new assets exceeds the cost of the old assets. This principle points directly to the source from which assets of this kind should be financed. The cost of the old assets should be collected out of the earnings of those years during which the assets were used, and the excess amount only should call for a new source of funds

6. *Buying out competitors*—This is not the place to go into a full discussion of the effects of competition. We may, however, venture a few observations. A strong concern, well founded and well operated, thrives on a certain amount of competition. Competition stimulates general interest in the product and serves to keep the concern "on its toes." Sometimes, however, the field is too narrow to support all the competitors. The stronger will likely buy out the weaker, or in effect do the same thing by making the competition more bitter until the weaker concerns perish. Sometimes this process disorganizes the trade and is generally unsatisfactory. It may seem to cost more to buy out the weak competitor, but in the long run it may prove profitable. Mr. Frank Munsey has on several occasions followed this practice in the newspaper field. It is said that he paid $1,000,000 in cash for the *New York Globe*, which he immediately practically dropped by combining it with *The Sun*.

7. *Consolidation.*—Expansion may take place through consolidation. Our own experience has shown us that the results

frequently prove more expensive when a stock arrangement is made than when a purchase for cash is made. Stock on such occasions is usually undervalued, and the stock offered to the smaller and weaker concerns proves an incubus that tends to dishearten the managers If the concern is at all successful, the managers soon realize that the holders of this stock are getting too much income for what they contributed. A fuller discussion of consolidation is given in Chapter XXIX. Here it is merely desirable to point out that at times consolidation should be looked upon as a form of expansion and should be treated as a problem to be solved on that basis.

To what extent should a concern expand?—Abraham Lincoln was once asked, "How long should a man's legs be?"



Theoretical Increase in Co-ordinating Overhead Necessitated by Adding a New Product

The reader will recall Lincoln's famous answer: "Long enough to reach the ground." And so the first answer to the question, how big should a concern be, is, as big as it can grow with increasing profits. The problem involves the two economic principles of large scale production and diminishing returns.[3] Books on economics will be found to contain a discussion of the law of diminishing returns, here we may simply point out that as businesses grow in size, they need new co-ordinating forces, the cost of maintaining which, after a while, offsets the advantages of large scale production. In

[3] The advantages of large scale production will be found in Chapter XXVIII The reader who desires to pursue the subject treated in this chapter should read Clark's "Studies in the Economics of Overhead Costs," and "The Successful Control of Profits," by Professor Walter Rautenstrauch

theory it works out this way: If a concern has one unit of product, A, and takes on a new unit, B, a co-ordinating system, X, must be built up. If a new product, C, is added, two new co-ordinating forces are required, Y and Z, X moving up to act as the co-ordinating force managing Y and Z. If another product, D, is added, the co-ordinating forces to be supplied will now, in abstract theory, number three, L, M, and N, and so on. The result up to this point is illustrated by the diagram on page 318.

The author's own observation leads him to believe that he cannot emphasize too strongly the need for caution in expansion. In the first place, if the step is unwisely taken, the profits of many patient years of hard work may be wiped out in a few months. We could relate dozens of stories, uncomfortable to the actors, to illustrate our point. Business men can probably recall many examples of unwise expansion in their respective fields or those of their acquaintances. The outstanding difficulty of the problem is that when the suggestion to expand is made, all the psychological elements are in its favor: lure of profit, pride of power, fear of competitors' preemption of the field.[4]

In every business there ought to be some conservative individual who will insist that the optimists "count ten" before urging expansion, and then further insist that for a new concern[5] the advisability of the proposed step be investigated in the way we have outlined in the first chapters of this book. Our experience is that business conferences on new products, or the establishment of branches, and like questions, easily resolve themselves into a discussion of how the thing can be done. To discuss that question first is reasonable enough, because before deciding whether a step should be taken we must decide how it can be taken But as the discussion veers over to this secondary question, the insidious assumption arises that the step *should* be taken and that the only question is, *how*.[6]

Measuring amount of funds needed for expansion.—In general, the same methods may be used for measuring the

[4] For one who wishes to pursue this phase of the subject we can recommend W. Sombart, "The Quintessence of Capitalism"

[5] For methods of planning ahead for capital needs, see next section of text

[6] The problem of expansion is tied up with fixed and variable costs. See Walter Rautenstrauch, "Successful Control of Profits," pages 114 *et seq.*

funds required for expansion as were already described for investigating a new project. In some lines of work quite definite relationships exist between the amount of gross income and the amount of investment. This relationship probably tends to exist in all cases where growth is homogeneous, as in the case of a gas company in which the entire plant tends to grow uniformly as new territory is served. In fact, in the whole public utility field, the rule holds good that for each dollar of gross income the business will require five dollars of investment. In a general way, therefore, the financial requirements of such concerns can be forecast from the tendency of growth of gross income.[7] In other cases, the need for funds for growth must be determined from a study of past experience, from accurate studies of the needs arising from plans for projected expansion, from estimated increases in the business due not only to definite plans for expansion but to natural healthy growth, and from special studies carried on in connection with engineering plans for improving efficiency.

The table on page 321 was adapted from a form of capital budget used by one of the largest industrial companies in the United States. The same plan may be adapted to even the smallest retail store. The theory on which the table proceeds is that the ratio of capacity of output, expressed in dollars of sales, to the dollars of investment in the respective departments, will remain the same. In column *A* is placed the computed maximum output of each department at its present capacity, expressed in dollars of sales. In column *B* is placed the present investment in equipment and all assets pertaining to the department. In column *C* is the ratio of capacity to investment. In columns *D*, *G*, *J*, *M*, and *P* are placed the estimated sales for successive years, the estimates being derived from figures obtained from the various selling agencies and checked up in the main office. The amount of investment in each department will remain the same as the original investment till estimated sales catch up with present capacity. When the percentages in columns *E*, *H*, *K*, *N*, and *Q* exceed 100 (these are the ratios of future annual sales in the respective years to present capacity), then figures will be placed in the investment column at an amount proportioned to present

[7] See diagram on page 324.

TABLE No. 7

CAPITAL BUDGET

Department	Present Position			One Year Later			Two Years Later		
	A *Capacity in Dollars of Sales*	*B* *Investment*	*C* *Ratio of A to B*	*D* *Sales*	*E* *Ratio of D to A*	*F* *Investment*	*G* *Sales*	*H* *Ratio of G to A*	*I* *Investment*
Department No 1	$ 100,000	$ 300,000	33⅓%	$ 75,000	75%	$ 300,000	$ 100,000	100%	$ 300,000
Department No 2	150,000	375,000	40	100,000	66⅓	375,000	125,000	83⅓	375,000
Department No 3	1,250,000	2,500,000	50	1,000,000	80	2,500,000	1,250,000	100	2,500,000
Department No 4	350,000	350,000	100	300,000	85 5/7	350,000	400,000	114 2/7	400,000
Department No. 5	250,000	375,000	66⅔	250,000	100	375,000	300,000	120	450,000
Total	$2,100,000	$3,900,000		$1,725,000		$3,900,000	$2,175,000		$4,025,000

Department	Three Years Later			Four Years Later			Five Years Later		
	J *Sales*	*K* *Ratio of J to A*	*L* *Investment*	*M* *Sales*	*N* *Ratio of M to A*	*O* *Investment*	*P* *Sales*	*Q* *Ratio of P to A*	*R* *Investment*
Department No 1	$ 125,000	125%	$ 375,000	$ 150,000	150%	$ 450,000	$ 175,000	175%	$ 525,000
Department No 2	150,000	100	375,000	175,000	116⅔	437,500	200,000	133⅓	500,000
Department No 3	1,500,000	120	3,000,000	2,000,000	160	4,000,000	2,225,000	180	4,500,000
Department No 4	500,000	142 6/7	500,000	700,000	200	700,000	800,000	228 4/7	800,000
Department No. 5	400,000	160	600,000	500,000	200	750,000	600,000	240	900,000
Total	$2,675,000		$4,850,000	$3,525,000		$6,337,500	$4,000,000		$7,225,000

investment, as the respective years' sales are proportioned to the present capacity. Thus in the third year, sales in department No. 1 will be 125 per cent of present capacity (column *K*); therefore, in that year the investment will be 125 per cent of the present investment, or $375,000 (column *L*). To indicate for each department years in which added investment will be needed, the figures in the investment column are printed in boldface whenever the investment of that year exceeds the investment of the previous year. In practice it is customary to underscore or draw a circle around the figure in red ink The most important figure for the financial management is that given on the "Total" line under the column of investment in each year. In planning ahead it is just as necessary to know how much is going to be needed ten years hence as to know how much will be needed in the next year. The limit of open-end mortgages and of stock authorizations can be properly set only when a long view ahead is taken.

Expansion determined by elasticity of personnel.—The extent to which expansion may be permitted depends on the elasticity of the present personnel. This question is one of management primarily, but if management fails, finance will be affected, and our purpose here is merely to call attention to the fact that frequently products or markets are added that are really not profitable, for in the first reckoning it may have been assumed that the present force would be adequate. Gradually new appliances are added, new people are engaged, and capital costs and operating expenses mount up, finally necessitating a financial revision.

Effect of expansion on working capital.—Expansion nearly always means an increase in working capital. The increase comes in two ways: first, as a temporary increase to bear the burden of getting the product started—equivalent to the demand by a new business for funds for "going concern value"—and second, as a larger permanent amount of working capital to carry the increased business. This subject is developed at greater length in the chapters on working capital.[8]

Expanding an individual proprietorship or partnership.—How do individual proprietorships and partnerships finance expansion? The most obvious answer drawn from experience is, they don't; they incorporate and then expand. Certainly

[8] See Chapters XXIII, XXIV, XXV. See also charts in Chapter XXI.

this statement is quite true when the business grows to require considerable outside funds. If sole proprietors take in partners, they divide control, this division may be avoided by incorporating and retaining an amount of stock that will insure control. If partnerships take in a great number of partners, the result is likely to be confusion. Our observation has been that firms with large numbers of partners have developed by taking in important employees as partners in order to enlist their enthusiastic participation in the work of the business, rather than by seeking to get their investment or the investment of rank outsiders.

Moreover, the growth of individual proprietorships and partnerships, even through reinvestment of profits, presents tax difficulties that the astute business man should seek to avoid. Partners are liable for Federal income taxes on all their earnings, whether withdrawn from the business or not. If the business is incorporated and the profits remain in the business for definite business purposes, the individual owners are not taxed and the business itself pays the tax.[9]

If, after considering these questions, a sole proprietor or a partnership wishes to retain an unincorporated form of organization (a business trust may be considered as an alternative), the means for raising funds are: (1) take in partners, (2) form a limited partnership and take in limited partners (this practice will effectually settle the question of control, since special partners have no voice in the business); (3) sell unnecessary business property, (4) increase the proprietor's investment by selling private investments, (5) borrow either with or without security or mortgage To a certain extent, the principles expounded in respect to corporations are applicable here and it seems unnecessary, therefore, to develop the subject further at this point, except to note the importance of the personal element in sole proprietorships and partnerships when they seek to attract new capital. Since these concerns cannot count on the ordinary channels of investment for

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[9] For a more complete discussion see Chapter IX On account of the high rate of surtaxes on large incomes (see table, page 176), some business men have found it to their advantage to give shares in their business to persons entitled to a claim on their bounty, thus reducing the rate of tax on their own income and reducing the aggregate tax on the entire income of the business If this is done frankly, unequivocally, and irrevocably, the result will be an avoidance of taxes to which there can be no objection See Bullen v Wisconsin, (1916) 240 U. S 625; Vol. III, American Federal Tax Reports, page 2,944.

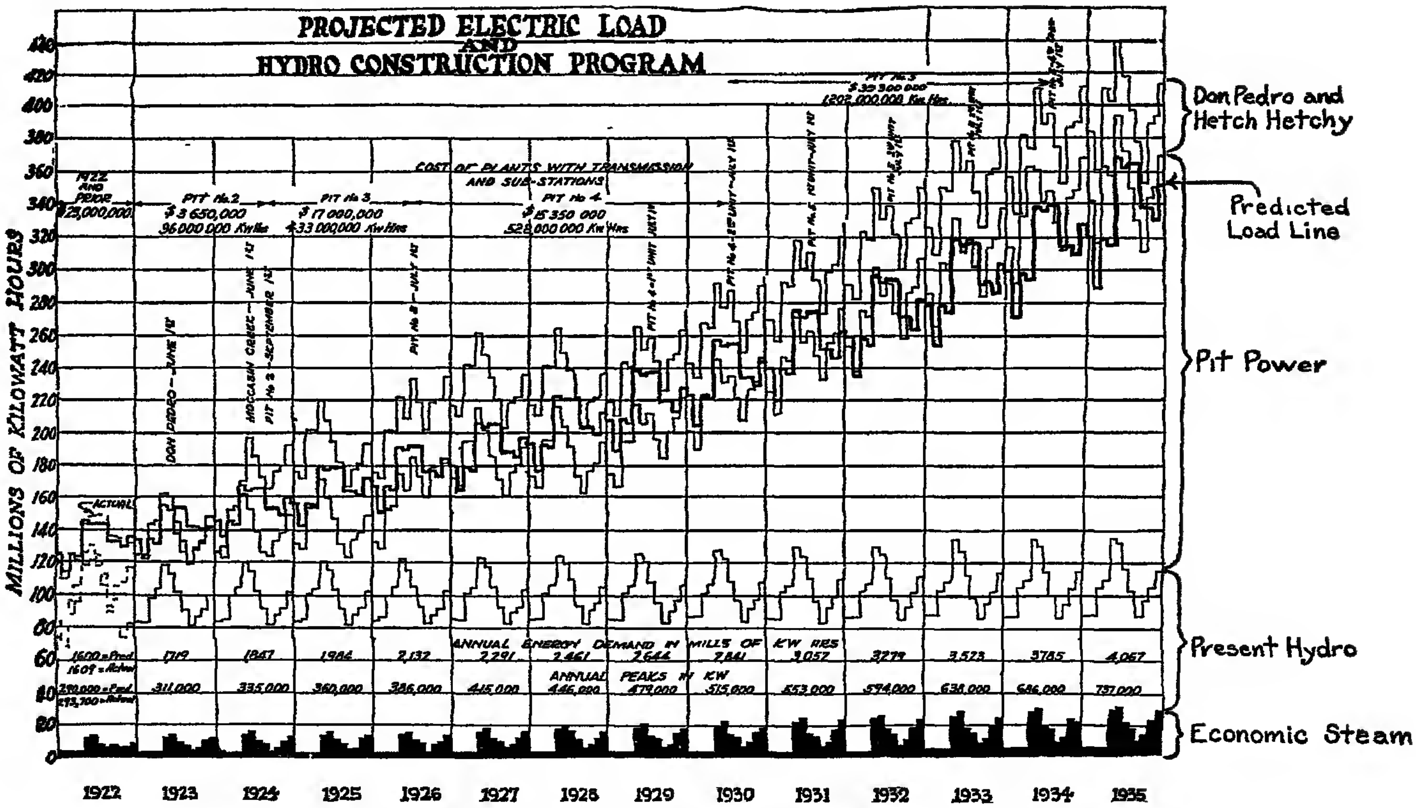

Diagram of the Equipment Budget to Show Its Relation to Output

"Pit Power" refers to power development on the Pit River. Don Pedro and Hetch Hetchy also refer to hydro-electric plants. "Economic Steam" refers to steam power used as auxiliary to hydro power. Notice in the years 1925, 27, 28, 29, 30, 31, and 35 how output meets equipment. (From *Pacific Service Magazine* of the Pacific Gas & Electric Co.) Upon inquiry in 1931 to determine the accuracy of the forecast, the Pacific Gas & Electric Co. wrote "The actual figures covering load for the period 1923 to 1930 have compared very favorably with the estimates indicated on the graph, after allowing for certain factors that could not be foreseen . . . the chief of which were the absorption of other power systems. . . . Our recent studies have been made in tabular form."

raising new fixed capital, but must count on the investments of individuals, personal relationships will have to be developed among people with means, who are able to make investments in such concerns.

How corporations can raise new capital funds.—Corporations may increase their capital investments in the following ways:

1. *Ploughing in surplus.*[10]—This may be done by (a) simply increasing the surplus account as profits are made; (b) creating liberal reserves for depreciation,[11] (c) labeling a part of the surplus as an appropriated surplus,[12] (d) "distributing the surplus" through stock dividends.

It is generally said that American concerns tend to expand out of earnings, while English concerns expand out of the proceeds of the sales of securities. We shall show in the chapter on dividend policies the fallacy of the American practice of postponing a division of the profits earned each year. Here we may simply call attention to the fact that while financing expansion from the proceeds of the business is conservative, it frequently leads to unfair discrimination between owners of the business. In partnerships this point is hardly well taken, for the proprietors, in the expected course of business, are to remain the owners. But in corporations, especially in the larger concerns, change of ownership is the normal thing, and it seems only proper that each "generation" should "pay its way" and that each "generation" should realize its own profits.

2. *Selling unnecessary assets.*—Unprofitable and unused assets, it would seem, should always be disposed of, whether the company needs the funds or not. If they are not needed,

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[10] During the recovery period of 1933 to mid-1937, there was an expansion of capital expenditures in most lines of industry While in previous expansion periods, such as the 1920's, the capital markets furnished a large part of new financing requirements, in the post-depression recovery, the new issues market supplied a negligible part of the capital The actual source was working capital, which had been built up by ploughed-in earnings, reserves for depreciation that had not been used, and other operations Another influence toward financing through working capital was the large government expenditures that stimulated buying and put cash into corporate treasuries See "Changes in Capital Financing," by Donald B Woodward, *Journal of the American Statistical Association*, March, 1938

[11] See discussion on page 555

[12] An example is the division of a bank's surplus account into "surplus" and "undivided profits," the former being equivalent to "appropriated surplus" and the latter to the ordinary surplus applicable to dividends in industrial and mercantile corporations See chapter on dividend policies

they may be invested in interest-bearing securities to serve as a working capital reserve

3. *Sale of stock.*

4. *Sale of bonds or notes.*

5 *Borrowing directly from banks on notes as security.*—In periods of excessively low interest rates corporations may borrow from banks, giving their notes as security, instead of selling securities. Besides obtaining funds at a reasonable cost through this method, the corporation management avoids the expense and inconvenience of filing a registration statement and otherwise complying with the Securities Act of 1933

6. *Borrowing on ordinary real estate mortgages.*—For small concerns this form of borrowing may be a satisfactory expedient, though small property mortgages of this kind may prove troublesome, firstly, because such borrowing is usually for a short term, and secondly, because the underlying liens thus given may interfere with future general corporate mortgage borrowing.

Of the five sources of capital funds enumerated, only the third and fourth need occupy our attention here. In the next sections we shall discuss the principles that should govern the issuance of stocks and bonds during the expansion of a company. (See chart in Chapter XXI.)

Keeping down the annual cost of capital.—Fundamentally, a business is run for the benefit of its owners. Capital for future expansion, therefore, should be raised by means that will keep down the annual cost of capital. Bonds are always best for this purpose, for the purchaser of bonds sacrifices size of income for safety of income. It must not be thought that reduction of annual cost of capital is the sole consideration, it would probably be better to say that, other factors being favorable, this is the paramount consideration. Bonds, of course, should never be used where there is any danger that the interest cannot be met regularly.

Let us assume, to illustrate the principles set forth in the previous paragraph, that we are trying to decide, as did the stockholders of the United States Steel Corporation in 1902, whether we should retire 7 per cent preferred stock from the proceeds of 5 per cent bonds, that is, whether we should substitute 5 per cent bonds for 7 per cent stock. The answer to the problem is a paradoxical statement: if the company can surely pay annually the larger item—the 7 per cent dividends

—then we ought to decide in favor of the smaller item—the 5 per cent interest; but if there is any danger that the company will not be able to pay the smaller item, then we ought to vote in favor of the larger item. We must have "safety first," but having that, we must next try to keep down our costs—an apt illustration of the saying · "The curse of the poor is their poverty."

Keeping down annual costs of capital is not so important where new securities can be sold to old stockholders. If a company is earning 40 per cent on its stock, it will not wish to share these earnings with new investors, the high rate of earnings is probably a just reward to the old stockholders who took all the original risks of the business. If new stockholders are to be brought in now on a reasonable basis, they ought to pay $400 or $500 a share for their stock. Or the company might write goodwill into its assets and declare a 300 per cent stock dividend to its old stockholders and then sell stock to outsiders at par. These expedients might be considered instead of the expedient of reducing annual cost by issuing bonds; they would hardly be as effective. But if the company could sell its stock to the old stockholders, each taking new shares in proportion to his holdings, the earning power would be kept "in the family"—there would be no dissipation of income among recent comers. It must be remembered, however, that even where the profits can be kept in the family, when a company has stable income and is successful it can afford to take the risks of issuing bonds, for by "trading on the equity," the return on the owners' capital is magnified.[13]

Keeping control.—In the second place, new securities should not be issued in such a way that control will be given away. If stock is issued and all the old holders of stock participate in the new issue in proportion to their old holdings, relative control will not be affected. But the amount of new funds needed may be too large for the old holders to supply, or the latter may wish not to add so large an investment in one enterprise in which they already have large commitments. The use of bonds or stock without voting power will settle the problem. These expedients were used by Charles M. Schwab in 1917, in financing a total expansion of assets amounting to $160,000,000.[14]

[13] See page 187.

[14] See page 305 for list of securities representing degrees of control

Avoiding risk.—Enough has been said in the section on "keeping down annual costs" and in the chapter on borrowing,[15] to indicate that risk must not be incurred where earnings are variable

Where financing is being done through the issue of bonds under an open-end or limited open-end mortgage, the escrow or restriction clauses will probably take care of an undue assumption of risk.[16]

Where preferred stock is being used, the cumulative feature may be so worded as to provide that arrearages shall not begin to accumulate until some time after issue, that is, after the property obtained from the proceeds of the sale of the stock has had ample opportunity to get into operation.[17]

Keeping the best security till the last.—Managers of corporate financing operations must always think of the rainy days, of the emergencies. The general rule is to keep your best security or some of your best security till the last.[18] Unissued bonds under a limited open-end issue are generally available in very large corporations and these may be made more attractive in times of great necessity by being deposited to secure short term notes.[19] Smaller companies can use ordinary real estate mortgages, or, if they have financed themselves in the past entirely with stock, may create a general corporate mortgage.

The cycles of trade.—We may not, for lack of space, go into the question of business cycles at great length, but we must indicate, in a general way, the relation of economic movements to the financial problem of expansion and management.

Economists recognize that the cycles of business caused largely by alternating periods of under- and over-production and by expanding and contracting credit are either major cycles, which are attended by periods of great inflation and periods of severe depression, or minor cycles. The major cycles may be said to run from one major depression to the

[15] See Chapter X

[16] See pages 223 *et seq.*

[17] See page 138

[18] We are not speaking here of emergencies in respect to working capital, but of emergencies that demand rush investments of capital funds An example of what we have in mind is the funding of a large floating debt incurred during rapid expansion in a period of great general business prosperity—for example, in the year 1919.

[19] See pages 261–263

next. During the sixty-nine years from 1870 to 1939 major depressions occurred in 1873, 1884, 1893, 1907, 1914, 1921, and 1930. The minor cycles of business activity occur within the major cycles. Thus, during the course of the major cycle that ran from 1921 to 1933, there were three minor cycles as follows: from 1921 to 1924, from 1924 to 1927, and from 1927 to 1933. Minor depressions in the past sixty-nine years

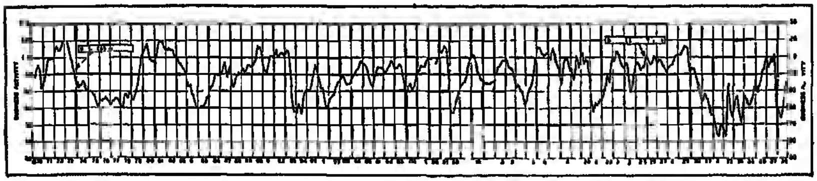

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Diagram Showing Major and Minor Cycles of Business Activity

have occurred in 1888, 1891, 1898, 1900, 1904, 1911, 1919, 1924, 1927, 1934, and 1937.

The chart above shows clearly the peaks of the business cycles.

Price movements are recognized as important in determining the course of business cycles, since rising prices encourage

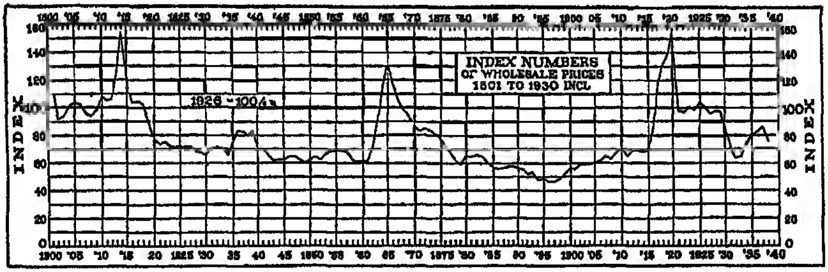

Diagram Showing the Long-Term Swing of Commodity Prices. The Post-Napoleonic Drop in Prices Lasted Forty Years, the Post-Civil War Drop Lasted Thirty-one Years; the Post-World War Drop Is Now Running Its Course

trade and declining prices curtail it. Fluctuations in the price level affect earnings and profits of producers, they affect the purchasing power of the consumer, and they tend also to affect interest rates and bond prices The price level, when compared with the production level, indicates whether stocks of merchandise are accumulating. For these reasons the business man must watch the movement of prices.

In the chart of prices since 1800 (page 329), a cyclical movement over long periods is visible.

In the pre-depression era, it was necessary for a business man to study the short cyclical movement of interest rates in connection with the problem of raising capital At that time there was a noticeable regularity in the seasonal changes in demand for and supply of funds, caused chiefly by the regular recurrence of dividends and interest payments by large corporations, by the seasons and their effect upon business, and by crop periods of planting and harvesting A study made by the *Harvard Economic Service* of seasonal variation in demand for and supply of funds showed that the early spring was normally the best time to raise funds. With the changes in the money market that developed during the depression and post-depression periods, the short cyclical movement was no longer apparent. Should the one-time normal conditions return, consideration of the short cyclical movement of interest rates may again become important.

The business man must also learn to know the peculiarities of his own business and those of the special markets which he enters either as buyer or seller. The problem here is not so much one of recurring cycles, but of alertness in recognizing conditions, and the direction and probable duration of changes in conditions, in the several lines of trade allied to the business man's own industry.[20]

What use may be made of the cycles.—From the standpoint of financial management, four distinct problems arise in connection with the cyclical movements of business:

1. Determination of buying and selling policies in relation to the need for funds.
2. Time at which funds ought to be raised.
3. Kinds of obligations to incur at different stages of the cycles.
4. Credit and collection policies.

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[20] The relation of the cycle of one industry to that of another is a very profitable study If a business man can discover some line of industry the ultimate periods of prosperity and depression in which procede the similar periods in his own industry by an approximately determined interval, he may lay his own plans on the basis of the changes in the correlative industry. See, for example, the relation of the industrial equipment business (machines and tools) to general industry, as worked out theoretically by W. C Mitchell in L. D Edie, "The Stabilization of Business," pages 24–26

Buying and selling policies in relation to cycles.—Buying and selling policies cannot be said to be affected very directly by the long cycle of price movements, but they are affected by the shorter price movements. In connection with trade activity cycles, the financial management must guard the company against undue expansion of inventories at the height of the active period; large inventories at such a time usually mean that the business is heavily in debt to firms furnishing materials and to the banks. When the reaction takes place, these obligations cannot be liquidated, for, in the first place, goods won't move at all, and then to get some money out of the inventories, prices will have to be slashed and a loss taken. Likewise, when the period of depression is well on its way, goods should be bought to take advantage of the low prices of the period of stagnant business.

So, in selling, plans must be made for sales campaigns when business is in the trough of depression; when these plans are ready to be put into operation, general business activity will help the campaign along. If the plans are delayed, by the time the full effect of the campaign is to be obtained general business may have made the turn into the period of depression and sales effort will be quite futile.

The foregoing points to the fact that funds are needed for buying and selling operations at the end of the period of depression and in the early part of the rise in business activity.

At what time shall funds be raised?—But we are faced with the question: is it better to raise funds when they are needed or when they are easy to raise? Little doubt can be entertained of the wisdom of raising funds when they are easily obtained, provided suitable provision can be arranged for making them available when needed.

The best time to raise funds is when business is booming and people are optimistic. Such a time occurs toward the end of the period of prosperity. But it is then that the wise executive will begin to put on the brakes. The wisest procedure is that which runs somewhat as follows: starting with the period of depression, when the business is making plans for sales and laying up inventories, and if necessary, planning and acquiring equipment for the coming period of rising activity, we find interest rates low and funds plentiful in the banks. Moreover, prices are low, the construction business is dull, and contracts for equipment and construction can

therefore be made to advantage. At this time the business man may borrow and buy on credit. Then as business booms, he may sell his securities at good prices and may pay off his loans. He is then in a strong position to weather the storm of rapidly falling business and may start the next cycle with the good credit standing on which this procedure is predicated.

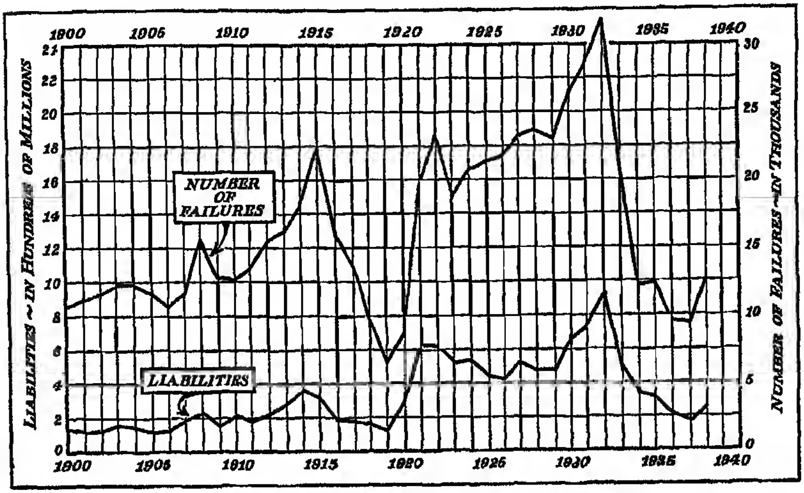
Time of the year to raise funds.—Investment bankers are careful in timing the sale of securities. In the past, the early spring was usually chosen. Investors had by that time received the first of the year interest and dividend payments, and since funds were not needed for agricultural purposes, they were easily obtained from the banks in order to purchase and carry securities. From 1933 on, the availability of funds was not a factor in the timing of the sale of securities, for money was plentiful at all seasons. Other factors, such as the condition of the bond market, war scares, and the like, influenced the timing of security sales. A careful program for the sale of securities will avoid an offering on or near the quarterly Federal tax dates.

Business cycles as they affect kinds of securities.—At the beginning of a long period of price decline, such as we entered in 1920, the sale of high interest-bearing long term bonds becomes the height of folly, for as time goes on, the dollars of interest paid to the bondholders constantly become more valuable—buy more goods. At the time mentioned—the beginning of a long period of price decline—bonds should be made short term, or redeemable, or the company should sell stock. At the beginning of a long period of rising prices, the company may well take advantage of the situation and sell long term low interest-bearing bonds.

If we consider now the major and minor cycles of business activity, we may be guided somewhat by what was said above, where it was suggested that at the end of the period of depression and at the beginning of a period of business activity, money might be borrowed. If funds are to be raised through the sale of securities at that time, bonds or short term notes may be used. These may be refunded into stock as the business cycle brings profits and enables the company to increase the dividend rate. If the bonds are made convertible, this refunding takes place automatically through conversion of the bonds, since the increase in the dividend rate enhances the market price of the stock and makes it profit-

able for the security holders to exchange their bonds for stock.

Credit and collection policy in relation to cycle.—If one compares the curve of business failures with the curve of business activity, he discovers that the general tendency of the failure curve is in the direction opposite to the curve



Business Failures and Liabilities Involved

of activity. In a general way, then, credits ought to be granted in a more restricted fashion as the activity curve creeps upward. Moreover, since toward the end of each year there is usually a seasonal increase in failures, in the early part of the year great effort should be made to collect old accounts; toward the end of the year it may be too late.

Progress of forecasting.—Economists throughout the world have given much study to the subject of business forecasting, and in this country they have used the wealth of statistical material which has become available since the World War to develop statistical computations and curves covering past performance on which to predicate forecasts of future business conditions.[21] While the economists and

[21] See the following books "Business Cycles and Unemployment," Report and Recommendations of a Committee of the President's Conference on Unemployment, 1931, L D Edie, "The Stabilization of Business", L H. Haney, "Business Forecasting", D F Jordan, "Practical Business Forecasting"; S S. Kuznets, "Secular Movements in Production and Prices", F. Lavington, "The Trade Cycle"; W. C. Mitchell, "Business Cycles, the Problem

professional forecasters have not achieved notable success as prophets,[22] the fact remains that they offer the only estimates of future activity based upon known facts, upon certain economic principles evolved from experience, and upon judgment as to the applicability of those principles to the forthcoming situation. Their forecasts cannot be ignored so long as business men must go on forecasting, and so long as no better aid is available.

Future financial needs should not be jeopardized.—A financial arrangement must always consider the probable effect of a present operation on future needs. For example, if only a comparatively small sum is needed today, a closed-end mortgage for that amount should not be given, the small underlying liens would embarrass the company later if it undertook to do some financing on a large scale. When a company is about to issue securities, it ought to consider, before it selects the form of securities to be issued, the effect of the proposed securities not only on the company and its credit at the moment of issue, but on the value of other securities, on the possibility of issuing other securities in the future, on the availability of future earnings for dividends to keep up the company's investment credit position,[23] and on the possibility

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and Its Setting"; Persons, Foster & Hettinger, "The Problem of Business Forecasting"; W M Persons, "Forecasting Business Cycles", C Snyder, "Business Cycles and Business Measurements" Current information can be obtained from commercial services such as Babson's, Brookmire's, Standard Statistics Company, and Moody's Investors Service Letters published monthly by some of the large banks are worth while The monthly bulletin of the Federal Reserve Bank of the district in which a business is located should be read each month Some of the larger banks publish excellent letters See, for example, the publications of the National City Bank of New York, and those of the Cleveland Trust Company

[22] See Garfield V. Cox, "An Appraisal of American Business Forecasts," 1930 This study appraises the correctness and adequacy of the general business forecasts of six organizations As stated in the study, "the results obviously do not in themselves justify one in placing implicit faith in any given forecast of any service, but they do support the expectation that the services will be right considerably oftener than they will be wrong"

[23] For example, if a company is relying largely on the sale of bonds under a limited open-end issue, it may be required by the escrow clauses to pay for a part of the cost of new property acquired in some way other than from the proceeds of the bonds. Unless the company is in a position to sell stock, it will have to use its earnings to supply the required "equity" Ploughing earnings into the property in this way prevents the payment of cash dividends, depresses the value of the company's stock, forces financing through the single channel of the bond issue, and makes the capitalization lop-sided with bonds. See C. W. Gerstenberg, "Materials of Corporation Finance," page 929.

of rearranging the financial structure of the company in the future [24]

Simplicity of financial plan.—Other things being equal, a simple financial structure is to be desired because it is easy to manage, and because it avoids the suspicions which unnecessary complexities arouse. One class of stock and one issue of bonds under one mortgage make for a clear understanding on the part of investors of the rights they are buying when they take the company's securities. The soundness of this general principle will be sustained by an examination of the financial plans of companies of varying degrees of success in the same line of business.[25]

Extra features to give attractiveness.—The management of a company ought to know all the tools of financing before beginning a financial operation. Such features as the various forms of sinking funds, redemption and conversion provisions, accumulation of arrearages, guarantees, and the like, all described in previous pages, should be carefully considered before an issue of securities is determined upon. As has been repeatedly pointed out, most of these features affect in some way the control, income, or risk of the owner. The question in each case is can an attractive feature be offered without unduly burdening the company, and if the feature is added, will the prospective purchasers' appreciation of the sacrifice be commensurate with the burden assumed? In a word, will the investor pay for what he gets?

Governmental control of capitalization.—Finally, the selection of corporate issues must depend on the latter's relation to government action. Railroads must get the consent of the Interstate Commerce Commission. Public utilities must have the approval of State regulating commissions and of the Securities and Exchange Commission, if the company is subject to the provisions of the Public Utility Holding Company Act of 1935. In addition, the tax situation must always be one of the elements that will determine the form of securities—stocks or bonds—chosen for issuance.

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[24] Bonds and preferred stock are usually made redeemable

[25] Compare, for example, the styles of capitalization of a dozen railroads and a dozen automobile companies.

Chapter XX

SELLING SECURITIES

Occasions for the sale of securities.—An offer of securities may be made by a going concern in need of additional capital, or it may be made by a newly organized company. The ease with which the former can dispose of its securities will depend upon the nature and proved success of the corporation and the characteristics of its offering. Newly organized enterprises find it comparatively hard to secure capital, the degree of difficulty depends upon their ability to impress prospective purchasers with their probability of success. A going concern has the advantage not only of past performance as evidence of the quality of its issue, but the further aid of appeal to a wider range of buyers. Whether its financing is to be made direct or through an agent depends upon considerations to be discussed later. In any case, much will depend upon the financial affiliations of the responsible managers.

Classes of buyers of securities.—Securities may be offered to old stockholders, old bondholders, to creditors, customers, employees, personal friends of the management, or to the general public. Of these possible purchasers, the last four—in the case of customers and employees, we mean, of course, prospective customers and employees—constitute the only prospects for newly launched companies.

Shareholders' rights.—A going concern desiring to market a new issue of stock must give its old shareholders the first opportunity to take up the new offering. Each stockholder may subscribe to the new issue in proportion to his stockholding; this inherent right is based on two principles: (1) permitting existent stockholders to keep proportionate control, and (2) preserving the equities in the surplus.

Effect of sale of stock on proportionate control.—The proportionate control of the old stockholders will be disturbed unless new stock, when about to be issued, is first offered to them. Suppose *A*, *B*, and *C* own stock in the *X* company in the following proportion: 100 shares, 200 shares, 300 shares. If the directors issue 12 shares to *D*, a friend of *C*, the latter

will control a clear majority, and if ordinary voting prevails, *C* may deprive *A* and *B* of representation on the board of directors. Under the rule of stockholders' rights to new issues, however, the 12 shares would have to be offered to *A*, *B*, and *C* in proportion to their holdings, and *A* and *B* would have the right to maintain their proportionate control by taking 2 shares and 4 shares respectively, leaving 6 for *C*.

Effect of sale of new stock on value of old stock.—The relation of new stock issues to the old stockholders' respective interests in the surplus can best be explained with the aid of the accompanying balance sheet.

A Company

Assets		*Liabilities*	
Total	$1,500,000	Stock	$1,000,000
		Debts	200,000
		Surplus	300,000

The net value of the *A* company to its stockholders is the value of the assets less the amount of debts,[1] that is, $1,300,000. If we assume that the shares have a par value of $100, then the book value of each share of the *A* company will be $130. If $2,000,000 of new stock is sold at par, the net value of the assets will be $3,300,000 and the value of each share, therefore, will be $110. In this case the new stockholders will get a share worth $110 for $100, and the old stockholders will see their shares diminish in value from $130 to $110 each. If, however, each old stockholder bought shares of new stock in proportion to his old holdings, he would get two new shares for each old one, since the stock of the company was increased by two shares for each old share. The $20 of loss suffered on the old stock would be made up by the $10 gained on each of the two new shares.[2]

Law of stockholders' rights to subscribe.—There seems to be considerable disagreement among the courts as to the true rule governing stockholders' rights to subscribe for additional

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[1] Since the total of liabilities is equal to the total of assets, we may express the above formula by taking the debts from the total liabilities. If we do so in the above example, it becomes clear that the net value of a corporate property to its owners is the sum of the stock and the surplus

[2] If the stock were sold at $130 a share instead of at par, the old stockholders would not suffer even if they were not given an opportunity to subscribe to the new shares But there would still be the question of unbalanced control that was explained in the previous section

stock. The rules promulgated by the different courts will be found in W. M. Fletcher, "Cyclopedia of the Law of Private Corporations." While the rules there set forth are not always in harmony with the rules given below, careful examination of the authorities cited will show that in the cases before the courts, either peculiar facts were involved or, to put it bluntly, the courts did not understand the underlying principles of proportionate control and of proportionate interests in the surplus. Statutes of the State in which a corporation is organized may vary the rules here given; such statutes would be valid, at least as to stock issued after the statutes were enacted. Sometimes the right to subscribe is waived by the stockholders in the certificate of incorporation.[3]

It is submitted, however, that in the absence of statute or charter provisions, the following rules should govern as flowing from the principles of proportionate control and of proportionate interests in the surplus: (1) The basic rule is that stock, before being sold to outsiders, should be offered to the old stockholders. (2) Stockholders who have no control and who have no interest in the surplus, ought not to be entitled to subscribe to new issues of stock. Stock to

[3] This was apparently true of the Utah Securities Corporation. Stock issues in which preemptive rights have been waived are more common since 1925 than they were previously. Several of the corporation laws provide that the corporation may in its articles of incorporation deny to stockholders preemptive rights to subscribe to new issues of stock. The Indiana Corporation Law now includes a provision that shareholders shall have no preemptive rights to subscribe to additional issues of shares of stock, except as provided in the certificate of incorporation or in a resolution of the board of directors. Laws like the Indiana statute are recommended as a means of solving the difficult problem of applying the principle of preemptive rights in cases where the financial structure consists of several classes of preferred and common stock with various preferences, rights, and limitations on voting power. See Drinker, "The Preemptive Right of Shareholders," 43 *Harvard Law Review* 586, 615.

In several of the States the statutes specifically provide that shares otherwise subject to preemptive rights may be sold free from the preemptive right under a plan for the sale of unissued stock to employees, upon the written consent or vote of a certain percentage of the stockholders entitled to exercise preemptive rights.

The elimination of the preëmptive right in issues of stock of corporations which are subject to the Public Utility Holding Company Act of 1935 must meet with the approval of the Securities and Exchange Commission. The Commission has indicated that it might require a prior offering to existing stockholders if it was deemed necessary to protect their interests in assets, earnings, or voting power, whether or not the preemptive right is denied in the certificate of incorporation. See John F. Meck and William L. Cary, "Regulation of Corporate Finance and Management under the Public Utility Holding Company Act of 1935," 52 *Harvard Law Review* 216.

which this refers would be non-voting, non-participating, preferred stock. The principle should apply in the case of non-participating stock for the very good reason that since the preferred stock is non-participating, the directors might distribute all the surplus to the common stockholders by declaring a sufficiently large dividend The directors, therefore, must have the right, so far as such preferred stockholders are concerned, to keep the surplus in the company, but to spread it over a greater number of common shares (3) In the same way that a new issue of stock will do so, the exercise of either the conversion privilege or the privilege to purchase stock by means of the stock purchase warrant may affect control of the corporation as well as dilute the existing interests of shareholders in the surplus. Old stockholders, therefore, should be entitled to subscribe to new issues of convertible obligations and to receive stock purchase warrants to the same extent as they would have the right to subscribe to the shares of stock issuable upon conversion or purchasable upon exercise of the warrants. (4) All sales of stock are to be made for the benefit of the corporation. For example, property may be acquired for stock without first offering the stock to the stockholders. This principle, it must be added, should be accepted with two provisos: (a) that the stock is taken by the vendor of the property at its book value, if the latter is greater than the par value or if the stock is without par value, and (b) that the transaction is not a mere fraudulent cloak for capturing control of the company. (5) When stock is to be sold, the stockholders must be permitted to maintain the *established* proportionate control and to maintain their respective interests in the company's surplus. For example, if a company is in the process of selling stock (that is, if control has not been definitely *established*), sales may be made continuously to new stockholders, but if the company has ceased selling stock and the proportionate control of the stockholders has been crystallized, and new stockholders have come into the company through purchase of shares from original stockholders and have relied upon the proportionate control obtained by such purchase, the corporation should not be permitted to offer its shares to outsiders without first making an offer to its own stockholders.[4] (6) In every case

[4] See Glenn v Kittanning Brewing Co, (1918) 259 Pa 510; 103 Atlantic 340

where a company sells all of its capital stock and thereafter increases its capital stock, the old stockholders who have control or an interest in the surplus should be permitted to purchase a number of shares proportionate to their holdings.[5] (7) Although, under the law, treasury stock is not subject to the preemptive right of existing shareholders, the directors should observe the principles governing the distribution of new issues and should first offer the treasury stock to existing shareholders if circumstances are such that any other action would be prejudicial to the shareholders' interests. The problem of applying the principle of preëmptive rights is complicated by the existence in modern times of various classes of participating preferred stocks, some with voting power and some without, some redeemable and others not, some convertible into one class of securities and others into another, and of various classes of common shares with all sorts of attributes. The directors should consider how each class of stock will be affected upon the issuance of additional stock of the kind agreed upon and should act in good faith in the interest of the shareholders in offering the shares, having in mind the rights of stockholders to proportionate interests in surplus and proportionate voting control.[6]

If its stock is worth more than par, a corporation is not bound to sell the stock to its stockholders at par, but it cannot sell the stock to outsiders at a price lower than that at which it was offered to the stockholders.[7]

Position of privilege holders with respect to rights.—A stock purchase warrant, which is a privilege to buy stock of a corporation at a certain price during a stated period, must not be confused with a warrant evidencing the right to subscribe to new issues of stock explained in the preceding pages. The main difference between the two is that the privilege of the holder of a "right" represents an interest in present property of the corporation which is to be distributed by offering stock at a price less than the book value of the old stock, while the

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[5] Stokes v Continental Trust Co, (1906) 186 N Y 285

[6] The following articles will be found helpful to an understanding of the effects of the complex modern structure upon preemptive rights Drinker, "The Preemptive Right of Shareholders," (1930) 43 *Harvard Law Review* 586; Fry, "Shareholders' Pre-emptive Rights," (1929) 38 *Yale Law Journal* 563; Morawetz, "The Preemptive Right of Shareholders," (1928) 42 *Harvard Law Review* 186 See also L L Briggs, "Some Legal Aspects of Stock Rights," *Certified Public Accountant*, April, 1935

[7] See contra, however, Hammond v Edison Illuminating Co., (1902) 131 Mich. 79, 90 N W. 1040.

privilege of the holder of a stock purchase warrant represents, at the time it is created, no present interest in property of the corporation, and no distribution whatever. The stock purchase warrant[8] may in the future, when the book value of the stock purchasable with it exceeds the subscription price indicated in the warrant, represent an interest in property and to that extent may require protection against dilution. The stock purchase warrant does not make the holder a stockholder and he is not entitled, because of the warrant, to the preemptive rights of stockholders, even though his warrant has come to represent an interest in the property of the corporation His contract may, however, afford protection against dilution of his interest. The holder of a convertible security is in the same position as the holder of a stock purchase warrant so far as possible dilution of his privilege through the issuance of additional stock is concerned. Since the conversion privilege does not make its owner a stockholder, he is not entitled to a preemptive right upon the issuance of additional stock, and whatever protection he gets must likewise be derived from his contract. We have seen on pages 146 and 152 that to protect the privileges represented by conversion and stock purchase warrants, the corporation may in its contract with the holders of these privileges agree that in case additional shares are issued at less than a certain price, an adjustment shall be made in the subscription price or in the conversion rate. We have also seen on page 147 that an additional protection is sometimes afforded by requiring that the privilege holder shall, through notice of the proposed issuance of additional stock, have an opportunity to exercise his privilege and become entitled to the preemptive rights of stockholders.

Number of rights to which stockholders are entitled.— New issues of stock are offered to shareholders at a fixed ratio. In other words, old shareholders have the right to subscribe to new shares up to a certain percentage of their stockholdings, depending upon the rate of increase in the capital stock. A corporation increasing its capital stock by 20 per cent must allow each stockholder the right to subscribe to the new issue up to 20 per cent of his holdings. In order to subscribe to one share of new stock under these conditions, he must own five shares of old stock. This privilege of subscribing to the new issue of stock is called a "right," and is

[8] See pages 149 *et seq.*

evidenced by a certificate called a "warrant," which is much like a certificate of stock. Fractional rights as well as full rights are issued. In the above case, a man with fifty-two shares of old stock would get ten full rights and two fractional ones, the latter he might sell or, with the purchase of three more fractional rights, convert into a full right.[9]

Disposition of rights.—A stockholder in possession of rights may exercise them or sell them.[10] The corporation generally specifies that the right will be given to stockholders of record as of a certain date and that it must be exercised by a definite later date. If the shareholder has not the means with which to purchase more of the stock, or does not care to exercise his privilege, he may sell the right. Generally a market is created for rights as soon as the company announces the offering of a new issue, the rights being sold for delivery "when issued." The existence of a market for the rights, however, is dependent upon the privilege having a value, which value arises when the price at which the new stock is offered to the shareholder is lower than the market price of the stock. Should the price of the stock fall,[11] the value of the right will

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[9] In 1921 the General Motors Corporation announced that it had established a clearing house for fractional stock warrants at its transfer office in New York City In the case of the one-eighth increase in the shares of the Cincinnati & Suburban Bell Telephone Co in 1917, no fractional shares were issued, but fractional rights were aggregated and sold, and the premium was divided among the stockholders pro rata to their respective fractions See discussion of fractional shares on page 568

For various examples of notice sent to stockholders explaining rights and the conditions under which they may be exercised, see C W Gerstenberg, "Materials of Corporation Finance," pages 358–366, and pages 1014–1018

[10] Sometimes the rights are not negotiable This was true of preferred stock rights offered in 1918 to holders of Montgomery, Ward & Co preferred stock.

[11] This happened in 1917 to rights to purchase $25,000,000 of stock of the New York Central, the proposed issue was not underwritten. It also happened to many rights that were caught in the stock market crash in 1929 In some instances the companies withdrew their stock offers and returned the subscriptions that had been received For example, an offering of stock was made by the North American Company in September, 1929, at $100 on a one-for-ten basis At one time after the offer, the stock was selling at 170 and the rights reached a value of $7⅛. The number of rights bought and sold totaled 1,180,-450 With the crash, the value of the right fell to 1/64 of a dollar and later its value disappeared entirely The price of the stock fell to $70, or $30 less than the subscription price for new stock As a result of this situation, the company withdrew its stock offer and returned the subscriptions that had been received With the cancellation of the offer, the rights really had no existence. The transactions in rights, however, were not canceled, and those who had purchased them with the purpose of taking up the stock suffered the loss of whatever they had paid for the rights.

diminish proportionately until it is wiped out when the stock ceases to sell at a premium above the subscription price. Since the occurrence of such a contingency is hurtful to the sale of the issue, bankers formerly resorted occasionally to artificial maintenance of the market, a matter to be discussed shortly in connection with the position of the stock exchange in the sale of securities.

When stock carrying rights is sold, the rights usually go with the stock until the day of closing the company's books for such rights,[12] after which time quotations of the stock on the stock exchange are made "ex-rights"[13] This means that the stock is bought and sold without the rights, and that the subscription warrants (rights) are bought and sold separately from the stock. Separate trading in rights continues until the expiration of the subscription period, when, if the rights are not exercised, they cease to have value In some rare cases a corporation will "redeem" unexercised rights and thus preserve the stockholders' equity in the surplus.[14]

The issuance of rights which have a low value is often seized upon by speculators as an occasion for making "short" sales of stock and protecting the sales by the purchase of rights.

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[12] That is, the day set by the company for closing its books, so that it may make up its list of stockholders and determine the number of rights to which each stockholder is entitled.

[13] During the period between the authorization of the issuance of the rights and the date set for closing the books, trading is said to be on a "rights-on" basis

[14] In 1917 Pacific Mills issued fractional shares instead of fractional rights These were transferable and if accumulated, could be exchanged for full shares If not exchanged, the directors had the right to redeem them for cash

Victor Morawetz, in an article entitled "The Preemptive Right of Shareholders," which appeared in the *Harvard Law Review* for December, 1928, objects to the practice of making warrants null and void unless the rights they represent are exercised by a specified date, in those cases in which the directors give the shareholders the right to subscribe to additional shares at a price materially below the market value The author says, " . the directors have the power, and it is their duty to protect the interests of their shareholders by providing that any shares not taken by them, or by their assignees of their rights, shall be sold for their account within a reasonable time after the termination of the rights to subscribe (if the shares can then be sold at a price in excess of the subscription price) and that any net surplus realized upon the subscription price shall be turned over to the shareholders or to the assignees of their rights, only the subscription price being retained by the corporation " It is submitted that this view overlooks the tremendous overhead cost involved not only in carrying through the plan, but in issuing the rights in the first instance. The old rule that equity protects the diligent would seem to be pertinent

If the stock moves down, the speculator profits to the full extent of the drop, less the cost of the rights and the commission, whereas if the stock moves up, however high, by exercising his subscription privilege the speculator limits his losses to the cost of rights, including the broker's commission.

Theoretical effect of rights on price of stock.—Though the surplus of a corporation remains intact, the issuance of subscription warrants or rights is equivalent to the declaration of an extra dividend to the shareholder, who, instead of using his rights as the basis of a subscription, sells them on the market [15]

For instance, the stock of a company with net assets of $1,000,000, capital stock of $800,000, and a surplus of $200,000, will be worth $125 a share. If the company were to sell $200,000 more stock at par to its old stockholders, the assets would increase to $1,200,000 and the capital stock would increase to $1,000,000. The value of each share of stock then would become $120. For the sake of clearness let us present the balance sheets before and after the increase in the capital stock.

Before Increase

Net Assets	$1,000,000	Capital Stock	$800,000
		Surplus	200,000
	$1,000,000		$1,000,000

Net assets $1,000,000 divided by 8,000 shares equals $125 value per share.

After Increase

Net Assets	$1,000,000	Capital Stock	$1,000,000
Received from sale	200,000	Surplus	200,000
	$1,200,000		$1,200,000

Net assets $1,200,000 divided by 10,000 shares equals $120 value per share

From this point of view the right to subscribe to a new share is worth $20, for the shareholder has been given the opportunity to subscribe at par to a stock that will be worth $120. This is the value of a right attaching to a new share,

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[15] In spite of a criticism of the text in an article by Russell D Garner and Alfred S Forsythe, entitled "Stock Purchase Warrants and 'Rights'," 4 *Southern California Law Review* 268,280, I do not believe it is necessary to change the text as originally written. The authors of this article argued that according to the text, " a 'right' is also in the nature of a cash dividend " They claim that "a dividend must be looked at from the standpoint of its creator, not its recipient " The whole section of the text, as its heading

and since four old shares are necessary to acquire the right to buy one new share (the capital having been increased 25 per cent, from $800,000 to $1,000,000), the value of the right attaching to an old share will be $5. Thus a stockholder owning one share may sell his right, in effect, his right becomes a $5 dividend and the value of the share he continues to hold falls proportionately, that is, to $120.

Formula for finding the theoretical value of a right.—The results shown above can be found by the use of the following formula:

$$\text{The value of a right equals } \frac{P \times R}{1 + R}$$

P means premium, or the difference between the market price of the stock and the price at which it is offered to the old shareholders. *R* means the rate of difference in the amount of stock outstanding, or the rate at which the old shareholders are given the right to subscribe. Using the illustration above, where $800,000 of stock worth $125 a share was increased to $1,000,000 and the new stock was offered at par to the old stockholders, we have the following:

$$\frac{\$25 \times 25}{1 + 25} = \$5, \text{ Value of a right}^{16}$$

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indicates, examines and intends to examine the effect of rights on the recipient's, that is, the stockholder's, position, for he is the one who is chiefly interested in "price of stock" From his standpoint, the right has the same effect as a dividend. If, as the text indicates, he sells the rights, then, though the text does not say at any place that the dividend is a cash dividend, it is indeed a cash dividend to him See the article mentioned for a very complete discussion of stock purchase warrants and rights and for many valuable citations

It may be added that the Federal Income Tax Law does not treat the receipt and sale of common stock dividends distributed to common stockholders as cash dividends (see page 570); the rule in such cases is that the shares sold are treated as part of the original shares purchased, increased by the dividend shares Thus, if I buy 100 common shares at 60 ($6,000) and get a 20-share common dividend, my cost per share is now $6,000 divided by 120, or $50 per share If I sold the 20 shares at $55 each, the taxable profit would be, not 20 times $55, but 20 times $5, or $100 In fact, whatever number of shares I sold at $55 would yield me a profit of $5 a share for tax purposes

[16] A few years ago the Philadelphia Stock Exchange dealt, not in rights as they are dealt in on the New York Stock Exchange, but in warrants, which meant that the rights were quoted on a basis of the value attaching to a new share. The "Philadelphia rights" always had as many times the value of a "New York right" as was represented by one share divided by the fraction of the rate of increase in stock Thus, if the stock were increased 40 per cent, or two-fifths, the "Philadelphia right" would be worth 5/2 times the "New York right" In the illustration given above, the value of the "Philadelphia right" would have been $20, that is, four times the value of the "New York right"

The market price of a new share is theoretically the price which the old shareholders will pay plus the value of as many rights as are needed to purchase one new share, or expressed differently, the market price of the old stock less the value of a right

Practical effect of rights on price of stock.—Theoretically, it is clear that the issue of new securities to which rights attach demands a downward revision of the market price. Practically, however, this adjustment is often nullified or possibly emphasized by the many other elements that determine price in the open market. New financing might be favorably interpreted as evidence of an increased volume of business and a sign of healthy growth. Interest in the company produced by press publicity and a favorable statement of conditions might, with increase of confidence in the ability of the company to maintain dividends on the increased capitalization, provoke an improved demand and consequently a higher price. Quick assimilation of a new issue might strengthen the position of the stock, or a generally bullish market might often more than offset the normal downward adjustment. On the other hand, a reverse condition, which is just as likely to prevail in any of the above determinants, may cause a drop in the stock far below what the "right" adjustment would seem to warrant. The downward tendency which theoretically should set in might not be attributed by the shareholders to a natural adjustment, and the skepticism of the few who did not understand the situation might cause some unloading that would push the price down lower than the level to which theoretically it should fall. The offering for sale of any large amounts of stock will have the effect of depressing values, and if speculators, anticipating a drop in the price, should sell short in quantities, their own actions might result in driving the price downward. If the shareholders felt that the premium on the stock was artificial and that bankers were "rigging the market," they would try to sell their stock while the price was being maintained. This would make the task of price maintenance more difficult and probably impossible, with the inevitable result of a further decline in price. The entire situation is one governed by the laws of supply and demand, and the price will go up or down depending upon whether the amount desired by purchasers is greater or less than the amount offered for sale.

Observation has shown that in most cases the old stock and the rights attain their highest value at the beginning of the subscription period, and decline materially in value toward the end of the term The causes of this movement are again governed by the laws of supply and demand. At the beginning of the period the increase in the supply of the stock does not make itself felt in the market, as the new shares begin to be dealt in in anticipation of their issue, the increase in the number of shares depresses the price of the old stock and the rights along with the latter. Another reason is that many stockholders postpone the sale of their rights to the last minute, thus bringing into the market a supply of rights at a time when there is little demand for them for the purpose of "evening up" odd lots, because those seeking additional rights for that purpose have attended to their purchases early in the period.

Mechanics of rights.—Shareholders are not always aware that rights are to be issued. Unless authorization for increasing the capitalization must be obtained by amending the corporate charter, in which case the stockholders must vote on the change, the directors alone decide on the financing. Sooner or later, however, the shareholders are notified by letter of their claims to rights and are informed of the terms on which the new stock is being offered, the purposes for which the funds are being raised, and the period during which the subscription privilege may be exercised. The warrant for the right to subscribe which is sent to the stockholder is a formal certificate specifying on its face the amount to which the shareholder may subscribe and the terms of the subscription; the reverse side contains the subscription blank and a form for assignment in case of transfer. By negotiating with the treasurer of the company, who is generally the officer in charge of all transactions concerning the rights, the shareholder, if he desires to use only part of the subscription privilege, may have his warrant exchanged for other warrants of the same aggregate principal amount, the separate warrants being disposed of as he may choose. Fractional rights are generally represented by certificates worded somewhat differently from certificates of full rights, and printed in a different color.

Damages for failure to recognize shareholders' rights.—Directors who fail to extend to stockholders the rights to which the latter are entitled, where such practice is legally

required, may be compelled, by a bill in equity, to accord the shareholder his "rights." If specific performance is impossible because the new shares are already in the hands of innocent purchasers, the shareholder may recover damages, the extent of his claim is measured by the difference between the price at which the injured stockholder could have purchased the stock from the company under his right and the value of the shares at the time of the company's refusal. Before suit can be instituted, the shareholder must have demanded the shares from the company and the latter must have actually refused to recognize the right

Old security holders as prospects.—The obligation to offer the stock first to the old shareholders is by no means a hardship to the company, a thoroughly satisfied stockholder is a very good prospect, and the larger the group of ready buyers of the company's securities, the lower will be the cost of disposing of the issue.[17] The complete absorption of a new issue by the old stockholders is, moreover, a reasonable sign that the purchasers are for the most part investors whose holdings will lessen the chances of harm to the company from manipulation by speculative traders. For these reasons, new issues of securities are frequently offered to old security holders who have no inherent right to subscribe Thus, though bondholders have no inherent right to subscribe to new issues of stock or of bonds, they are often given the privilege of subscribing to a new issue of stock that has not been fully subscribed for by the old stockholders. Neither stockholders nor bondholders have an inherent right to subscribe to new issues of bonds, but the privilege to subscribe to bonds or notes may be extended with advantage to both bondholders and stockholders[18] The difficulty, however, with offering rights to bondholders is that unless such holders are registered, they are not easily reached

Offering securities to creditors.—Another group of buyers that may be approached by a going concern is its creditors, though the practice is usually limited to cases of readjustment and liquidation, where the stock of the new organization is

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[17] "New England Telephone, in the last twenty years, has gone to its stockholders thirteen different times for money, and always with a hearty response on their part" *Boston News Bureau*, September 6, 1917

[18] An example is the sale in 1924 of $5,000,000 of debentures to the stockholders of the Maxwell Motor Corporation.

offered to the creditors of the old company in full settlement of the debts. Specific instances illustrating such arrangements are quoted in the chapter on reorganizations and readjustments. Occasionally, however, creditors of a prosperous concern may be expected to make investments as a token of appreciation and as a bid for continued patronage Probably some of the large electrical equipment companies have made investments in customer companies for these reasons.

Customer ownership.—In the matter of selling to customers, the newly organized company has obviously a limited field of appeal, whereas the going concern, with its established trade, finds the customer who is familiar with the business and its earning power a good prospect. The co-operative distribution of profits to the very ones who make the profit possible is appealing. The corporation, by having its customers own the stock, is assured of their patronage. The plan is very well adapted to public utilities, which have much to gain by making the public financial partners in the enterprise. If the users of the service are its owners, there is sure to be less friction and misunderstanding between the service company and the public. While industrial concerns may part company with a disgruntled customer, public utilities must continue to serve, and good feeling, therefore, is quite imperative. With a wide customer ownership, the likelihood of political opposition and legislative attack is lessened. Stability of ownership through small lot sales allays the evils of speculation. Public utilities, through extension of rails, wires, or pipes, can continually expand their operations, and they therefore have constant need for the funds that may come from a continuous sale of securities to customers. Besides these advantages, there is the possible advantage of economy that may result from selling securities direct. This economy is discussed on pages 377–9. Moreover, corporations selling securities to customers have often obtained better prices for their stock than the shares were worth, sometimes, unfortunately, through the use of sharp practices in their selling campaigns. A corporation that overcharges for its stock always faces the danger of earning the ill will of its customers if its promises are not fulfilled or if the customers discover that they can get the same stock at a lower price through a broker.

Customer ownership has for the most part been promoted through the sale of preferred stocks, a practice which has

proved beneficial not only to the owner but to the corporation as well. The owner has found that his preferred stocks can resist the pressure of a stock market collapse. The corporation has found that by marketing preferred stocks that substantially maintain their values during a severe depression, it is in a position to continue to carry on ownership distribution. Furthermore, the financial structure of corporations resorting to the practice of selling stock to customers has improved, as compared with that of concerns which do not follow that practice. The improvement lies in a reduction of funded debt and the elimination of heavy fixed charges. Where customer ownership is not used in financing additions to capital, the corporation generally secures funds through the sale of securities, with the aid of a banker. Repeated attempts at raising capital through bankers invariably result in issues of bonds and notes, obligations which create burdensome fixed charges.[19]

The sale of stock to customers makes for diffusion of ownership, a situation that has a distinct social and economic value.[20]

The success of customer ownership in the public utility field has been truly remarkable. The National Electric Light

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[19] See Bruner, "Influence of Customer Ownership on the Financial Structure of Public Utilities," *Journal of Land and Public Utility Economics*, Oct., 1925.

[20] The diffusion of stock ownership, whether it be through customer ownership, sale of stock to employees, or a scattering of shares through other means, tends to make the public better acquainted with securities and to give them a clearer understanding of the economic functions of capital

In recent years there has been a persistent growth in the number of stockholders of record From the period 1916 to 1921, a great diffusion of ownership occurred, wealthy people representing a much smaller proportion of all corporate stockholders in 1921 than had been the case prior to 1916 From 1921 to 1927, the proportion represented by large stockholders remained fairly constant, in spite of the increase in the number of stockholders of record. See "Diffusion of Stock Ownership in the United States," Gardiner C Means, *Quarterly Journal of Economics*, August, 1930 This study shows that the total number of stockholders in 31 large corporations for which information was available from 1900 to 1928, increased steadily from 226,543 in 1900 to 1,419,126 in 1928 A later study shows that from the first quarter of 1929 to the first quarter of 1933, common stockholders in 50 leading corporations increased from 1,626,-000 to 3,500,000 After the first quarter of 1933, the figure started to decline and at the beginning of 1937 had fallen off 100,000 See Loman, "Changes in Secondary Distribution of Equity Securities," 33 *Journal of American Statistical Assn*, No 201, p 21. Separate figures are presented for growth of the number of stockholders in the three largest corporations: the American Telephone & Telegraph Co, the United States Steel Corporation, and the Pennsylvania R. R. In the American Telephone & Telegraph Co, the number of stockholders increased from 10,000 in 1901 to 647,000 in 1938; in the Pennsylvania R. R. from 28,408 in 1902 to 214,532 in 1938; and in the United States Steel Corporation from 15,887 in 1901 to 219,727 in 1938.

Association appointed a committee to study the subject, which committee obtained data from 156 electric light and power companies. In 1914 the companies which attempted to sell to their customers succeeded in selling 92,310 shares and in obtaining 4,044 new stockholders. In 1922 the 156 companies sold 1,750,707 shares and obtained 198,018 new stockholders. During the nine years from 1914 to 1922, 3,433,338 shares were sold to customers by the 156 companies and 423,587 new customer-stockholders were obtained. Since the total number of customers was 7,698,313, about 5½ per cent of all customers became stockholders. Seventy-five of the companies reported on the cost of selling per share. The average cost was \$4.39, the extremes being five cents per share in one case, and \$9.64 per share in another case. It should be added, however, that all these figures include sales made not only to customers, but to employees and others, without the aid of a financial agency. The committee of the National Electric Light Association recommended that the sale of customer ownership securities be conducted (1) through the sale to employees, (2) through employees to customers, (3) through paid salesmen devoting their entire time to the activity. The general experience seemed to indicate the necessity for having a certain number of paid and trained salesmen at all times.

Later figures—for example, those given in the 1930 report of the National Electric Light Association[21]—show that more shares were sold to customers in 1927 than in any one year since customer ownership became popular. A total of 3,581,206 shares was sold in that year to 249,491 customer-shareholders. In 1924, however, a still larger number of customer-shareholders was added, namely, 294,467, who purchased a total of 2,478,165 shares. The unusual stock market conditions during 1927–1929, when common stocks were in demand, told in the record of customer stock ownership. In 1929 many of the utilities resorted to financing through the sale of common stock, which caused a decline in customer ownership activities. In that year only 1,447,853 shares were sold to customers and only 87,498 customers made purchases of the stock.

[21] The National Electric Light Association was succeeded in 1932 by the Edison Electric Institute. No later data than that mentioned above were available in 1939 on the subject of customer ownership. The public utility companies made practically no effort during the thirties to raise capital through selling securities to customers.

In the industrial field, the original American Druggists' Syndicate[22] offers perhaps the best illustration of sales to customers. This company, with approximately 10,000 shareholder-agents who possessed practically all the stock, sold its products mainly through its stockholders and thus was assured of a constant demand for its manufactures. That the stockholders were thoroughly satisfied with the plan is unquestionable, for in 1920, when the stock was increased 100 per cent, every shareholder exercised his "rights" and doubled his investment in the company.

Selling securities to employees.—A corporation can rarely, if ever, depend upon its employees to furnish needed capital through the purchase of its stock.[23] Organizations which have made a practice of offering their securities to employees have done so primarily to maintain the goodwill of the workers and have adopted the practice as a profit-sharing scheme.[24] The United States Steel Corporation, which inaugurated the policy in 1903, even purchased back its own securities in the open market at times in order to be able to offer them to its employees. Payment being on an installment basis, the rais-

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[22] This company merged with the Vadsco Sales Corp in 1929, and stockholders exchanged their stock for shares in that company

[23] There are exceptions to this statement In 1921, it was said of Bell Telephone stock that "one shareholder out of every four is a telephone employe, and one telephone employe out of every four is a stockholder" *Saturday Evening Post*, May 21, 1921, page 12

[24] A study of employee stock purchase plans, made by the National Industrial Conference Board, shows that employee ownership became popular in 1919 and that from then to 1923 the number of plans instituted was on the increase In 1924 a decided decline was indicated No figures are available showing the number of employee stockholders added by the adoption of plans, and it is impossible also to tell whether there was a decline in the number of new employee stockholders as a result of the decline in the number of concerns instituting employee stock purchasing plans

Employees who looked upon their stock ownership as a grant from management or as a profit-sharing scheme were sorely disillusioned when, during the depression, they found their investments not only shrinking in value but in some cases becoming a liability Management also regretted the losses to their employees and in many cases took steps to alleviate the condition While employee stock-ownership as a profit-sharing scheme and as a preventive of industrial conflict has not been abandoned in industry, many of the larger corporations have abolished their plans The United States Steel Corporation terminated its employee stock subscription and profit-sharing plans in 1935 The American Telephone & Telegraph Co. discontinued its stock purchase plan as to acceptance of further subscriptions in 1933 and wound up the plan a few years later. See "Survey of Experiences in Profit Sharing and Possibilities of Incentive Taxation," Senate Report 610, 76th Congress, 1st Session (1939) p. 203 for comment on abandoned stock ownership plans

ing of capital by such sales can enter into the question only as a minor purpose. Managers of relatively small companies, however, may be successful in turning to salaried employees to satisfy their moderate demands for new capital. On the whole, the subject of employee ownership is a study more appropriate to a book on management than to a book on finance.

Reliance upon friends to furnish capital.—A successful going concern of some size may be able to raise capital without resorting to an appeal to personal friends of the managers, whereas a newly organized company or a small going concern might find such an appeal the only source for obtaining new fixed funds. This method tends, however, to convert what should be a business relation into a personal obligation, a condition that may have serious drawbacks. Moreover, the friend whose investment is sought may be as difficult to convince as any skeptical prospect.

But it must not be imagined for one moment that friends of the proprietors of a business, be it a partnership, or a corporation, or any other of the previously enumerated forms of organization, are an unimportant source of funds. In many cases, as is above indicated, they are the only source, and rightly so. Objection may be raised at once that we have pictured a hard state of affairs for many business men, the question is asked: what of the man or group of men who have no friends with available funds? The question may be answered by another question what of the business man who has no brains, or no technical skill, or experience? Let it be understood immediately, then, that the cultivation of friends with financial means is an important task of every executive. He must let such men know of his ability and of his proved moral worth. Mr. Charles R. Flint, in his "Memories of an Active Life," says that James Stillman, the elder, when asked for his formula for success, said, "I have always cultivated the acquaintance of the rich." And we might add to this the statement made to the author by a man very well known in business and banking circles, the late Mr. George Plimpton: "Early in my life I discovered that it was just as easy to associate myself outside my business with men of means as with men without that power, and I made it a rule to seek out the acquaintance of big men and to maintain that acquaintance."

Selling securities to the general public.—Although stockholders, bondholders, creditors, customers, employees, and

friends provide much investment capital, it is the general public that absorbs by far the greatest share of financial offerings.[25] These offerings may be classified as pure investments, legal investments, business men's investments, and speculative securities.

Pure investment securities.—A pure investment provides the investor with a security possessing ready marketability, definite minimum rate of income, and great safety as to principal. The investor assumes a minimum of risk and in return sacrifices control in the corporation, a high rate of income, or both. Among such securities are bonds protected by a mortgage on property whose earning power is several times the amount required for interest. To eliminate the element of risk still further, the issuing corporation should be a going concern the nature of whose business and the personnel of whose management will without doubt guarantee stable earnings. Preferred stocks of well established corporations with excellent dividend records (especially when such stocks are cumulative, protected, and have preference as to assets) are given a high investment rating. Common stocks generally fall short of a high investment rating, since their value moves too freely with the fluctuating earnings of the corporation. However, the standard of investment security is occasionally approached by the stocks of corporations which supply an article or service for which there is a constant demand, engage in an industry with thoroughly understood and standardized processes, offer a low financial risk, hold an established record of dividend payments, present an excellent financial history, and are undisturbed by poor management or manipulation by controlling interests.

The people who buy what we have called pure investments are those who may invest their funds as they please, but who are chiefly dependent on the income from their investments.

Legal investments.—A security having all the desirable characteristics mentioned above may yet, by law, be an improper investment for fiduciaries—trustees, savings banks, and life insurance companies, the three great classes of investors. The investments of such institutions are governed

[25] See footnote 20, page 350, for growth of public's interest in security purchasing. The public has been educated in the buying of securities by direct efforts on the part of investment bankers to interest small investors through customer ownership campaigns and through the liberty bond sales campaigns.

by laws differing in the various States. In New York, if no documentary instructions are given the trustee, the State laws governing investments of savings banks apply. These laws enumerate the kinds of securities that may be purchased, they exclude the stocks of any corporation, the bonds of industrials, the bonds of public utilities unless these meet certain requirements, real estate mortgages outside New York State, railroad bonds which are not first mortgages in whole or in part, and unimproved real estate. The only investments permitted to trustees are various forms of government securities, real estate mortgages on property within the State, and railroad and public utility bonds issued by companies which have been able to meet certain requirements as to earnings. Trustees who make investments not permitted by the State are liable personally for any loss that may be sustained. Though securities that cease to be legal after they have been purchased by trustees need not be sold immediately, they must be disposed of within a reasonable time. In most States, a railroad or a public utility must have an unbroken dividend record of about five years[26] before its bonds will be restored to the list of legal investments; in order, therefore, to preserve the investment credit of a corporation, its managers must use care to keep the eligible bonds on the "legal list"—once off, they remain off for five years.

Business men's investments.—Securities which promise a fair rate of income with little risk are sometimes called business men's investments. The business man may take a greater risk than the trustee, who is holding securities for people whose sole income is likely to be derived from the proceeds of the trust estate. He is willing to take some risk, but in choosing his investments he demands a fairly high rate of income. The company whose securities he selects need not have an established record, nor need it be more than a going concern of recent organization whose managers, the business man feels, can take advantage of a growing market for the company's product. In any event, the corporation must be substantial and the outlook must promise stability. Business men's investments embrace most preferred and many common stocks of strong industrial companies.

[26] In 1931 the Legislatures began to show a disposition to mitigate the rule temporarily because of the depression

Speculative securities.—The difference between investment and speculative securities lies wholly in the element of risk, which, in turn, depends almost entirely on the amount of knowledge available concerning future earnings. This latter, in fact, determines the classification of any security, and since every gradation of risk may be found in the securities placed on the market, the delimitation of the classes of securities can by no means be arbitrarily fixed. A security may pass from the stage of speculation to that of pure investment. But when a security has been issued by a newly organized company whose performance is yet to be tested, by an oil company without settled production, by a mining project, or, in fact, by any pioneer project, it is unquestionably a speculative security.

Security rating.—Several publishers of investment services[27] undertake to compile all information pertinent to securities of corporations and to publish ratings of securities for which statistical material is available. These ratings take the form of symbols, which are explained in the particular publication. It behooves the company management, where such rating is given, to maintain for its securities as high a position as possible. Indeed, every corporate official ought to look ahead to the day when the securities of his company will be rated. In the meantime, if proper attention is given to the factors that make for good rating, securities will be more salable than they would be if the investor's viewpoint were entirely neglected until the very moment when a new issue is about to be launched.

State regulation of security issues.—In most States, securities cannot be offered to the public without the consent of some official body exercising the powers of what are generally known as the blue-sky commissions. The laws of the several States are not in agreement; persons and corporations undertaking to sell securities should consult the statutes of the several States in which the securities are to be offered.

The blue-sky regulations are of two types.[28] (1) laws, generally called blue-sky laws, designed to prevent the

[27] The best-known agencies are Moody's Investors Service, Fitch Services, Standard Statistics Service, and Poor's Services

[28] See "A Study of the Economic and Legal Aspects of the Proposed Securities Act," prepared by the U S Dept. of Commerce, outlining the history of securities legislation in the United States.

issuance of fraudulent securities, and (2) laws of a punitive character, called anti-fraud acts. Most of the laws regulating the issuance of securities come within the first group; in the second are those of New York, New Jersey, and Maryland.

While the blue-sky laws vary considerably from State to State, they generally make two requirements: (1) that dealers engaged in direct offerings of securities be qualified, registered, or licensed, and (2) that the sale of specific issues which are subject to the laws be licensed. The fundamental idea is to protect the public from general offers of securities the value of which may be questionable. Securities of admitted strength, including government issues, offerings of railroads and public utilities which are subject to approval by State regulating bodies, and securities listed on the New York Stock Exchange and other established exchanges, are exempted from the blue-sky requirements.

Concerns—generally including Massachusetts trusts as well as corporations—making offers of securities in the State, whether they have an office there or not, are subject to the provisions of the law. In practice, however, sale of securities by mail from outside the State cannot be controlled except through co-operation with the Federal postal authorities.

Regulation of dealers may involve the filing of reports giving the names of the members of the firm and a statement of its resources, the filing of a bond, and the payment of a license fee. The regulation of specific issues generally involves an application for a permit to sell a particular security in the State. The application calls for detailed information concerning the security and the terms on which it is to be sold. The commission is given authority to make an independent examination. The compensation of the promoters is sometimes put under the control of the commission and stocks which the promoters receive are required to be deposited in escrow with the commission till the corporation has shown that its earning power justifies the price at which the securities are sold. Disputes between the commission and dealers are settled through appeal to the courts.

The securities commissioners of the States have drawn up special rules relative to issues of investment trust securities.

State control of public utility issues.—Public service corporations are now generally required to operate on the plan

of cost of service plus a reasonable return on the capital invested. In order to simplify the problem of public utility rates, most public service commissions have been given authority to regulate the issuance of securities by the corporations under their jurisdictions. Before a corporation can issue securities of any kind, an application must be made to the public service commission, stating the form of security and the purpose for which the proceeds are to be used The public service commission may withhold its permission, and in such case will usually write an opinion giving its reasons.

Federal regulation of security issues.—While State regulation of security issues has done much to protect the investor, it has not been entirely effective owing to lack of uniformity in the State laws, and to evasions made possible through sales on an interstate basis. To overcome these weaknesses Congress enacted the Securities Act of 1933, which went into effect on May 27, 1933. The Federal Act does not interfere with the operations of the State blue-sky laws,[29] or with the functions of the State public service commissions in their regulation of security issues. Congress also passed the Securities Exchange Act of 1934 to safeguard the public in security transactions through stock exchanges and other securities markets. For an explanation of this Act, see page 369.

Securities Act of 1933, as amended.—The Securities Act of 1933 has been referred to throughout this text wherever it has had relation to the subject under discussion. Here the purpose is to show the nature of Federal regulation of the issuance of securities. The Act requires that before new offerings of securities are made to the public by the use of the mails or the channels of interstate commerce, specific information concerning the new offering be disclosed in a registration statement which must be filed with the Securities and Exchange Commission The Act exempts certain issues and transactions, contains certain requirements as to the contents and use of prospectuses in connection with the sale of securities, and imposes civil and criminal liabilities for violation of the Act and for sale of securities through fraud or misrepresentation. Some of the provisions will be referred to briefly.

[29] See Russel A. Smith, "The Relation of Federal and State Securities Laws," 4 *Law and Contemporary Problems* 241 (1937); same author, "Blue-Sky Laws and the Federal Securities Acts," 34 *Mich L. Rev.* 1135 (1936).

Exempt securities and transactions.—Registration, the act of filing a registration statement, is required for all classes of securities—that is, stocks, bonds, debentures, notes, voting trust certificates, and the like—except those specifically exempt from the Act. The exempt securities include. (1) United States Government obligations, (2) territorial bonds, (3) obligations of Federal instrumentalities, such as Federal land bank bonds; (4) State and municipal obligations, (5) railroad securities, (6) short-term paper; (7) securities of building and loan associations, (8) receivers' certificates; (9) certain issues aggregating less than $100,000, at the option of the Commission, and (10) securities which are part of an issue sold only to residents of one State, provided that State is the State of incorporation of the issuer, and one in which the issuer is doing business.

The classes of transactions which are exempt from the Act include: (1) transactions by persons other than the issuer, underwriter, or dealer, (2) transactions in new issues, not through an underwriter, and not involving a public offering, (3) brokers' transactions executed upon unsolicited customers' orders; and (4) exchanges of securities in recapitalization and reorganization plans.

The prospectus.—As a further means of acquainting the purchasing public with the character of the securities offered, the Act requires that the sale or delivery of securities must be accompanied or preceded by a prospectus which must contain information similar to that set forth in the registration statement.[30] Certain requirements are set up by the Act for keeping the information in the prospectus up to date in cases where it is used more than thirteen months after the effective date of the registration. The prospectus is further discussed on page 380.

Effective date of registration and stop orders.—Ordinarily the registration statement becomes effective on the twentieth day after receipt of the statement by the Commission. If it appears that the registration statement includes any untrue statement of a material fact or neglects to state any material fact required to be stated therein, or necessary to make the

[30] The average buyer of securities does not see the registration statement which is in file in Washington, D. C. However, the leading statistical services and financial journals analyze the statements that are of interest generally, and publish important facts disclosed therein.

statement therein not misleading, the Commission may suspend the right to sell the securities by issuing a stop order. The stop order ceases to be effective when the registration statement is satisfactorily amended to meet the Commission's criticisms.

It must constantly be borne in mind that the purpose of the Act is not to prevent the sale of speculative securities, or to pass upon the value or soundness of any security. Its sole function is to see that full and accurate information as to the security is made available to purchasers and the public, and that no fraud is practiced in connection with the sale of securities.

Securities supervised by Interstate Commerce Commission.—Under the provisions of the Transportation Act of 1920, the right to regulate the issuance of securities by steam railroads has been vested in the Interstate Commerce Commission. As indicated above, the Securities Act of 1933 exempts railroad securities from the necessity of registration and from the requirements as to contents and use of prospectuses.

Supervision under the Public Utility Holding Company Act of 1935.—The Public Utility Holding Company Act, which is administered by the Securities and Exchange Commission, requires registration by companies which own or control 10 per cent of the voting power of retail electric and gas companies, or which otherwise exercise a controlling influence. The Commission exercises jurisdiction over such registered holding companies and their subsidiaries with respect to the issuance of securities, security transactions, intercompany loans, and other financial and administrative matters.[31] A declaration, calling for information somewhat similar to that required for the registration of securities under the Securities Act of 1933, must be filed with the Commission with respect to any proposed issue of securities. The declaration becomes effective unless the Commission finds that the security issue fails to meet the standards set forth by the Act for determining the financial structure of a company and the nature of the securities which may make up that structure. Sales cannot be undertaken until a declaration is effective.

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[31] See pages 696 *et seq* for further discussion of other methods of controlling holding companies under the Public Utility Holding Company Act of 1935.

Chapter XXI

SELLING SECURITIES (Continued)

Classes of ultimate purchasers of securities.—In the previous chapter we outlined at the outset the classes of persons to whom a special appeal could be made in the sale of corporate securities. Before turning to the general public as an outlet for the sale of stocks, bonds, and notes, we made a classification of these securities on the basis of their investment positions We are now ready to classify the persons and institutions that make up the so-called general investing public. They are as follows.

Classes of Purchasers:

Trustees, savings banks, insurance companies. (6)
Business and philanthropic organizations. (5, 6)
Persons dependent on investment income. (4, 5, 6)
Business concerns. (4, 5)
Business men. (3, 4, 5)
Speculators. (1, 2)
Investment companies or investment trusts. (1, 2, 3, 4, 5, 6)

The numbers after each class refer to the following classes of securities of which the respective classes of purchasers are prospective buyers.

Classes of Securities:

1. Common stock of new companies.
2. Preferred stock of new companies.
3. Common stock of old companies.
4. Preferred stock of old companies.
5. Bonds of old companies.
6. Bonds of special companies (railroads, and in some States, public utilities).

This tabulation, it will be understood, provides only a rough guide. An old company's securities may be just as much of a speculation as the securities of a new company. The investment position of a company depends on its demonstrated ability to earn regular income for its security holders.

Sale of securities in units.—A sale of securities in units is an arrangement whereby a certain number of shares of preferred stock and a certain number of shares of common stock of the same company are sold together for a fixed sum. For example, the sale of the convertible preference shares of the Hershey Chocolate Corporation was made in units of ten convertible preference shares and three non-par common shares for $740 per unit.

The sale of stock in units may be considered a variation of the bonus plan under which common stock was given, without a price attached thereto, with the sale of preferred stock. The unit plan attributes more importance to the common stock than the straight bonus plan. The sale of shares in blocks or units accomplishes the following additional purposes: (1) the securities are made attractive to investors who look for an opportunity to get more than a fixed return when the company's profits expand; (2) the corporation maintains a definite relationship between outstanding preferred and common stock; (3) stock can be sold in such units as will meet the demands of investors at the time the securities are issued. Thus, the units may consist of preferred stock, warrants to purchase more preferred stock, and common stock; or preferred stock, common stock, and stock purchase warrants for additional shares of common stock. If securities are sold in units requiring an investment of a large sum of money, the distribution of the securities will naturally be made among a smaller group of investors than if each share is sold separately.

Agencies through which securities are sold.—Sale of securities is effected directly or through agencies. The usual agents are investment houses[1] These may be classified as wholesalers, combined wholesalers and retailers, and dealers or smaller retailers. The wholesaler buys directly from the corporation and depends upon retailers and small dealers to distribute the securities. Only a few investment houses, Morgan Stanley & Co. and Kuhn, Loeb & Co., for example,

[1] Since the enactment of the Banking Act of 1933, a national bank or state bank which is a member of the Federal Reserve System may not underwrite securities on or after June 16, 1934, nor may any national or state member bank be affiliated after that date with any organization engaged principally in the issuance or distribution at wholesale or retail of investment securities National and state member banks of the Federal Reserve System may buy and sell stocks solely upon the order and for account of customers, and to a limited extent for their own account.

limit themselves to purely wholesale dealings. Most of the larger investment houses act as wholesalers and retailers, buying whole issues of securities alone or with others in a purchase group, and distributing the securities to individual investors or institutions.[2] Retailers distribute to individuals or institutional investors the securities which they have obtained by joining a selling group, or for which they have obtained a dealer's allowance. They sometimes, however, buy whole blocks of securities from a corporation and resell a part of the issue to other houses.

Most investment houses sell securities of any corporation regardless of the industry. Some, however, specialize in particular classes of securities. Thus, Bonbright & Co. have long been known as specialists in public utility securities.[3]

The investment banker's business is to make money by buying an issue at one price and selling it at a higher. It is not his business to purchase for the sake of the income from the securities. He will keep a security perforce if he cannot sell it, but only until he can find a purchaser or a generally improved market. If compelled to carry a security himself, the banker is in little better position than a merchant who cannot dispose of the goods on his shelves.[4] Although bankers are very careful in the selection of securities which they buy, their judgment is not infallible. The bankers who purchased at 98 the issue of $48,000,000 of 3½ per cent debentures of the Bethlehem Steel Corp. in 1937, were compelled to hold almost the entire issue on account of a decline in the market price to 78[5] If the issue offered to a banker is

[2] When a firm buys new securities from an issuer, it is performing the function of an *originator* and is known as the *originating* house, when it purchases securities from an originator as part of a purchase group, it is called a *participant* (See, however, footnote 15, page 404) The function of underwriting was becoming so highly specialized toward the close of the thirties that a sharper segregation of the underwriting function from the retailing function was becoming noticeable See Chapter XXII, "Underwriting, Syndicating, and Distributing Securities"

[3] As a practical expedient, the lists of security dealers may be consulted These are usually arranged geographically See, for example, "Bankers and Brokers Directory," published semiannually by Williams & Co , New York City; and "Security Dealers of North America," published by Herbert D Seibert & Co , New York City.

[4] The great difference between the banker and the commodity merchant is that the former may borrow money using his wares as collateral without cost—the return on the securities usually being equal to the interest on the loan—whereas the latter's commodities are not self-sustaining in this way

[5] See Hearings, Part 13, Investigation of Railroads and Holding Companies, p 5585.

too large for him to handle alone, he may form a syndicate, the participants in which agree to purchase a certain portion of the issue. The nature and functions of the syndicate, which is known as a "purchase group," are discussed in the following chapter.[5a]

Functions of the investment banker.—The investment banker's main function is to sell securities to his clients. Before he is in a position to do this, however, certain important incidental functions arise. These may be listed as purchasing, advising, protecting, selling, trading, and service[6] If we understand these functions, we shall realize why it is true that some bankers are more successful in selling securities than are the self-styled bankers who are not equipped to perform such functions, and why the well organized investment bankers are generally more successful in selling securities than a company that undertakes to sell its own stocks or bonds. Large investment houses generally perform all of the functions described below; smaller houses may be equipped to perform only some of them.

The purchasing function.—The investment banker's clients are investors and business men; the securities he offers must be investments, or else the risk involved in them must be described The banker must be careful, therefore, to know exactly what he is purchasing.[7] This the banker with his force of experts and statisticians is in a position to do. An investigation made by a banking firm will cover a general and commercial research made by statisticians in the buying department, an engineering examination generally conducted by engineering experts employed by the buying department, a legal examination conducted usually by a well-known firm of corporation attorneys likewise employed by the buying department, and an audit conducted by an employed firm

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[5a] See footnote 15, page 404

[6] Prior to the enactment of the Banking Act of 1933, investment houses also performed the function of banking. It was the common practice for customers to leave funds with the investment house for safekeeping until enough was accumulated to put into further investments Under the Act, no person, firm, corporation or other organization engaged in the business of issuing, underwriting, selling or distributing securities may, after June 16, 1934, engage in the business of receiving deposits Nor may a private banker engage in the security wholesaling and retailing business For restrictions against national and state banks, see footnote 1.

[7] The Securities Act of 1933 places such great responsibility upon bankers who offer new issues of securities, for defects in the registration statement, that most careful investigation is essential for their protection.

of accounting experts. Such an investigation into the corporation's past record or into the circumstances surrounding a new project, yielding a comparison with other companies in the same line of business, together with a general understanding of the conditions of the market, provides the banker with data from which to judge the advisability of purchase. The result to the banker and to the client, assuming that the former acts intelligently and courageously on the facts developed by the investigation, is the reduction of risk to a minimum Since such an investigation consumes time and is expensive, the investment banker may make a preliminary contract with the corporation taking an option on the issue for a certain period. This prevents the corporation from negotiating with any other bankers while the interested banking firm is making its study.

Advising the corporation and the client.—Investment bankers act as financial experts in giving advice to corporations and in working out financial plans. Because of their knowledge of financial conditions, they may determine the appropriate type of security to issue, whether stock, bonds, or notes, and in this way make possible the successful completion of financing. Moreover, the banker advises his corporate client as to the most appropriate time to float an issue

To his customers, the banker gladly furnishes advice or information on any security. He may offer to examine the investments owned by his customers and make recommendations for changes that will benefit the investor. He may also offer to prepare analyses of security issues in which the customer is interested Generally, no special charges are made for such services.

The protecting function.—Another service which the banker renders the security holder is that of protecting his interests. This frequently entails representation on the board of directors of the company whose security is underwritten,[8] and continuous oversight of the management. The banker also assumes the role of protector of his clients in cases of default, receivership, and reorganization.

The selling function.—The investment banker reaches investors through advertising, through a sales staff, and

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[8] The investment banker is not so ready as he formerly was to be represented on the board of directors of issuing corporations, because of the liabilities imposed upon directors by the Securities Act of 1933.

through correspondence.[9] During his selling campaign he usually inserts advertisements in the leading newspapers[10] and financial magazines, giving the name of the issuing corporation, a history of the company, the size, title, status and provisions of the issue; dates of interest or dividend payment, the price and denominations in which the securities are offered, the name and address of the investment banker, and generally, a financial statement of the company's position.[11] An offer of new issues is made only by means of the offering prospectus which is filed with the Securities and Exchange Commission in accordance with the requirements of the Securities Act of 1933. Distributors of securities are extremely careful to see that every purchaser receives a copy of the prospectus, for the Act specifically provides that it is unlawful to use the mails or the instruments of transportation in interstate commerce to carry or transmit any security for the purpose of sale or delivery unless accompanied or preceded by a prospectus that meets the requirements of the Act.

The investment banker employs a staff of salesmen well-trained and intelligent—men who can approach people of means on a fair footing and who can quickly acquire some understanding of the business of the corporation whose securities they are selling. Specialist retailers here have an advantage over jobbers in that their salesmen, always selling the same class of security, become familiar with its typical features, whereas the general retailers, selling at one time a

[9] The Securities Act of 1933 has practically eliminated the use of the mails in connection with the distribution of new issues If the mail is used to call the attention of investors to the offering, the distributor is very careful to indicate that the announcement is under no circumstances to be considered as an offering of the securities for sale or as a solicitation of an offer to buy any of the securities, and that the offering will be made only by the official prospectus

[10] See pages 380 and 415

[11] A statement in the advertisement that "All the above bonds (or stock) having been sold, the advertisement appears as a matter of record only," does not necessarily mean that all the issue has reached the hands of investors. Usually it means that the syndicate, whose members' names appear in the advertisement, has sold out all the securities to a selling group For process of such sale, see Chapter XXII, Underwriting, Syndicating, and Distributing Securities Such advertisements constitute a service which the originators render to the selling groups in bringing the issue to the attention of the buying public Members of the selling groups frequently call their clients on the telephone and ask, "Did you see such and such an issue in the morning papers?" They usually add, "We have an allotment and can let you have blank shares or bonds." Many sales, especially in prosperous times, are made in this way.

tobacco security and at another a railroad issue, frequently bear the burden of having first to give their salesmen some information about the respective businesses whose securities are to be sold. Thus, to sell a security issue of the Consolidation Coal Co., a group of bankers preceded their campaign with a series of lectures for their bond salesmen on "The Geology of Coal," "Methods of Mining Coal," and "The Plants and Properties of the Consolidation Coal Co." The returns of such preparation for a selling campaign more than repay its cost.

The trading function.—In the distribution of securities certain situations arise that involve the investment house in trading First, there is the necessity for maintaining the price of new issues in the market during the period of distribution.[12] Second, the investment house must dispose of securities turned in by investors who have switched their old holdings to acquire the new issues. Third, it is frequently advisable for the firm to make a secondary market in issues originally offered by the house by maintaining bid and asked prices in the issues. The trading department of an investment house carries out these functions and in addition executes commission orders for customers in the open market.

The service function.—Investment houses also serve their customers in such ways as holding securities for safekeeping, collecting interest and dividends, giving notice of called bonds or stocks, informing customers of opportunities to profit by conversions, answering inquiries for information, making available to customers sources of information concerning securities, and advising them on income and estate tax matters in connection with security holdings.

Private sales of large issues.—Since the passage of the Securities Act of 1933 there has been a marked tendency for corporations to sell their new or refunding issues directly to the investor, usually a small group of insurance companies. This method of financing dispenses with the use of investment bankers and avoids the necessity for complying with the registration and prospectus requirements of the Securities Act of 1933, since no public offering is made. Corporations favor this method of selling their securities because it offers the following advantages: (1) Expenses are smaller than those

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[12] See page 426.

involved in a public offering.[13] (2) The financing is effected more quickly than through a public offering because the time generally involved in registering the securities and distributing them is saved. (3) The corporation is more certain of carrying through its financing program at a definite time. The agreement with investment bankers generally contains a provision under which the bankers may be released in the event of adverse market conditions. While this provision is rarely invoked, unfavorable market conditions will delay final sale of the securities. (4) The credit of the corporation is enhanced because it is generally known that insurance companies buy only the best securities. The improved credit may enable the corporation to market other securities publicly with greater ease. (5) If securities are closely held, adjustments that may become necessary because of unforeseen contingencies, such as inability to meet sinking fund requirements, interest, or principal payments, are more easily arranged than if the securities are widely distributed.

These advantages far outweigh the one important disadvantage to the corporation—namely, that it foregoes the opportunity which may arise when securities are publicly held, of effecting savings by purchasing the securities in the open market at a discount to meet sinking fund requirements or to reduce outstanding indebtedness.[14]

Selling with the aid of the stock exchange.—The stock exchange provides an outlet for the sale of securities; there the representatives of buyers and sellers of securities meet and trade. It would seem, then, that if the banker can have the securities which he is selling listed on a stock exchange, he may dispose of a large part of the issue to customers who are

[13] All or part of the following costs are saved to the corporation. underwriting commissions (see page 370); registration fee of $\frac{1}{100}$ of 1 per cent of the aggregate offering price; printing of registration statements, prospectuses, circulars, and indentures; advertising, and fees of attorneys, accountants, and experts who prepare the registration statement The additional costs incident to registration of bond issues in excess of $1,000,000 have been estimated at from $\frac{1}{8}$ to $\frac{1}{2}$ of 1 per cent of total proceeds These costs, however, are offset by lower compensation of underwriters (see footnote 22). See Goldschmidt, "Registration Under the Securities Act of 1933," and Gourrich, "Investment Banking Methods Prior to and Since the Securities Act of 1933," 4 *Law and Contemp Prob* 19, 44 In a private sale the cost of preparing securities is also reduced considerably since deliveries are made in large denominations

[14] For criticisms of private financing from viewpoints other than that of the corporation, see Rodgers, "Securities Privately Offered," 52 *Harvard Law Review* 773, and references there given.

not his regular clientele but who trade generally in listed stocks and bonds. Traders on the stock exchange are for the most part speculators who operate to take advantage of market fluctuations If the issue is small, the opportunity for an active market and consequent fluctuations will not arise and only a small portion of the securities will be disposed of through speculators. A large issue, however, is almost invariably listed on the exchange.[15] The fact that a security is to be listed recommends it to many people who insist upon have pledgeable and readily salable investments

Listing may put the banker in the position of having to guard the price and keep it up to the figure at which it is being sold to his clients. In pre-depression days, investment bankers frequently remained continuously in the market as a stabilizing factor, not only during the period of initial distribution, but for a more extended time. In recent years, market support operations have been considerably curtailed.[16]

Federal regulation of security exchanges by Securities Exchange Act of 1934.—The Securities Exchange Act of 1934 brings under Federal control the security exchanges of the United States by making it necessary for all such exchanges to be registered with the Securities and Exchange Commission as national securities exchanges before their facilities may be used. The Commission may exempt certain small exchanges if it deems registration unnecessary to protect the public The Act also requires the registration of brokers and dealers engaged in over-the-counter markets. Control is further exercised by restricting transactions on national securities exchanges to those securities which have been officially registered with the exchanges, or which are legally exempt from registration. The exempt securities are limited, in general, to obligations of the United States and its instrumentalities, and State and municipal bonds. Registration of securities with the exchanges is therefore required of all corporations which desire to list their securities on the exchanges. To obtain registration, the corporation must file an application with the exchange, containing certain required

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[15] Frequently, contemplated new issues are dealt in on the smaller exchanges (for example, the Curb, in New York) "when, as and if issued," before they are formally produced by the corporation

[16] The reasons for this curtailment are discussed in connection with the trading account in the chapter on Syndicate Underwriting, page 427

information, and such copies with the Commission as the latter may require. It must also agree to keep the information reasonably current.

Registered exchanges must comply with the rules and regulations of the Commission with respect to listing requirements and operations. Corporations whose securities are listed on registered exchanges must file annual reports, and quarterly reports if so prescribed, and certain information reports that must be kept reasonably current.[17] The Act places liability upon those who issue incorrect statements.

The Act regulates security markets not only by requiring registration as described above, but by forbidding unfair practices on the markets,[18] by controlling credit used in security transactions, by compelling corporations to furnish adequate information as to securities publicly traded in, and by curbing unfair use of information by corporate insiders.[19]

Banker's profits.—The bankers' profits come wholly from the difference between the price at which he purchases the security from the corporation and that at which he sells it, or from a commission which is paid on the issue. Such factors as the nature of the corporation, the type of security, the relationship of the banker with the issuing corporation,[20] the condition of the investment market,[21] the size of the issue, and other elements may enter into the determination of the spread between the price to be paid by the bankers and the offering price to the public.[22] The profit on highly speculative securities is higher than that on less speculative issues.

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[17] See footnote 24, page 49, and footnote 4, page 103.

[18] See footnote 13, page 311

[19] See page 121.

[20] Kuhn, Loeb & Co were the bankers for the Missouri Pacific system over a long period of years At the Congressional investigation of the relations of the bankers with the railroad, the bankers testified that during the period from 1921 to 1930, inclusive, the gross commissions to the bankers who underwrote the securities for the Missouri Pacific system were about $9,500,000 on securities in the principal amount of approximately $350,000,000 On the total securities the gross spread was about 2⅝ per cent, and the net profit of Kuhn, Loeb & Co, principal underwriters, was about 8 per cent See Part 13, "Investigation of Railroads, Holding Companies, and Affiliated Companies," page 5608 (1938)

[21] The spread tends to be lower in periods of prosperity than in periods of depression During the four or five years of heavy security sales prior to the crash of 1929, competition among investment bankers for the purchase of corporation securities forced the margin of profits to a low point and weakened the position of many of the smaller investment bankers

[22] Studies of underwriters' compensation before the enactment of the

If the banker expects to dispose of an entire lot with very small expense, he may be willing to undertake the sale at a smaller commission, provided the issue is large enough to give him a fair profit. If a proposition requires too great a commission charge in order to give the banker a fair profit for his efforts, the large reputable houses will not accept the undertaking It is generally understood that the established houses in New York, for example, will not touch an issue of less than $1,000,000.

Securities Act of 1933 indicated that from 1920 to 1931 the average gross compensation on issues of domestic railroad bonds was slightly less than 3 per cent of the par value of such issues For the years 1927 to 1931, for a sample of high-grade domestic corporate bonds, the average spread was about 3 per cent of par value The gross spread on a sample of preferred stock issues of $2,000,000 or over floated in 1929 (nineteen in number) averaged about 5 per cent of the offering price The spreads narrowed following the enactment of the Securities Act of 1933 After active financing got under way in 1935, the average spread for bond financing was from 3 per cent to 2½ per cent On preferred stocks sold during 1935 and 1936, the average spread on eighteen such issues was about 4¼ per cent of the offering price From Gourrich, "Investment Banking Methods Prior to and since the Securities Act of 1933," 4 *Law and Contemporary Problems* 44 (1937) See also footnotes 13, 21, and 23

A Securities and Exchange Commission analysis of 1937 issues (Release No 13, Statistical Series, Aug 3, 1938) shows the following average underwriting commissions and other expenses for the issuance of bonds, notes and debentures, preferred stock, and common stock, expressed as a percentage of the principal amount. The "other expenses" include listing fees, registration fees, revenue stamps, State qualification fees, trustee fees, printing and engraving, legal expenses, accounting expenses, engineering expenses, and miscellaneous.

	Bonds, Notes, and Debentures		Preferred Stock		Common Stock	
	Underwriting Expenses	*Other Expenses*	*Underwriting Expenses*	*Other Expenses*	*Underwriting Expenses*	*Other Expenses*
Under $250,000	5 9	3 3	14 3	3 0	19 9	2.5
$250,000 to $499,000	6 4	2 9	17 5	2 0	17 8	2 0
$500,000 to $749,000	5 6	4 2	10 0	1 8	17 2	1 9
$750,000 to $999,000	2 8	1 4	14 1	1 6	15 8	2 4
$1,000,000 to $4,999,000	3 3	1 5	8.1	1 2	14 3	1 4
$5,000,000 to $9,999,000	3 6	1 2	3 2	0 5		
$10,000,000 to $24,999,000	2 1	1 0	2 8	0 5		
$25,000,000 and over	1 8	0 5	2 7	0 3		
All securities	2 1	0 7	4.4	0 6	15.8	1 8

The registration statement required to be filed under the Securities Act of 1933 calls for a detailed list showing all commissions or discounts to be paid directly or indirectly by the corporation in connection with the sale of the securities to be offered. This publicity in regard to bankers' profits throws light upon a subject previously surrounded with secrecy.[23] The Act does not grant the Securities and Exchange Commission power to pass upon the reasonableness of underwriters' commissions. Under the Public Utility Holding Company Act of 1935, however, the Commission has power to require affirmative proof of the reasonableness of any fee paid in connection with the issue, sale, or acquisition of any security by a registered holding company or subsidiary, where it appears to the Commission that the corporation and the bankers have not dealt at arm's length.

Advantages of selling through an investment banker.—Several advantages flow from selling through investment bankers.

(1) A corporation that turns over its issue to a banker is at the outset reasonably assured of its successful sale. Companies have not infrequently been compelled to enlist the aid of bankers after an unsuccessful direct campaign. In 1903 the Pennsylvania Railroad offered its shareholders new stock at 120 while the stock was quoted at 143. The market price, however, dropped to 125 and the shareholders failed to subscribe to the $75,000,000 stock offered them. The issue was then turned over to bankers who were willing to take it at 120 in consideration of a commission of 2½ per cent on the entire issue.[24]

(2) The company may proceed to execute the purposes it has in view, knowing through its agreement with the banker just what funds will be available at any time. It does not have to wait until the close of a campaign before it learns how much money will have been raised.[25]

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[23] Whether the publicity has had any influence on underwriters' commissions is difficult to say. Gourrich, in the article cited in the preceding footnote, suggests the following explanation for the decrease noted (1) issues represented in the analysis were of higher quality, mostly for refunding purposes, (2) registration has simplified the bankers' task in distributing an issue.

[24] Cleveland and Powell, "Railroad Finance," page 25

[25] See Chapter XXII, Underwriting, Syndicating, and Distributing Securities. See C. W. Gerstenberg, "Materials of Corporation Finance," pages 412–420, for an interesting example of an attempt to promote a railroad without the help of bankers, and the disastrous results.

(3) The corporation is relieved of the considerable burden of conducting a selling campaign.

(4) The corporation generally finds it cheaper to sell through a banker. The latter, with his selling force already organized, with his copy writers already trained in preparing financial advertisements, and with his list of prospective buyers already in his files, can undoubtedly conduct a campaign at a much lower cost than a corporation, which is practically undertaking a new business when it attempts to market its own securities. This is true almost without exception in the sale of pure investments, which a banker will undertake to market at much less than 10 per cent.[26]

(5) The corporation that markets through a reputable banking house thereby adds prestige to the issue and to the company.

(6) The corporation gets the advice of the banker as to how to finance.

(7) The corporation may depend upon him for future aid in financing.

Other selling agents.—If a corporation is unsuccessful in securing the services of a reputable and recognized banker, it may offer its securities to another group of agents who, to some extent, perform the functions of a banker. These organizations differ from the investment house in that they have no established clientele but depend upon their salesmen to sell the issue in small lots. The salesmen make what are termed "one-call" sales. The prospect is usually a man of small means—a laborer, or an office clerk. The salesmen canvass from building to building in assigned or unassigned territories with subscription blanks in hand and are prepared to make actual delivery of the security upon payment of the subscription.

Self-organized agents.—Not many years ago a concern, the Federal Adding Machine Company, used a unique organization for selling its securities. Salesmen were procured who were instructed first in the sale of the securities and

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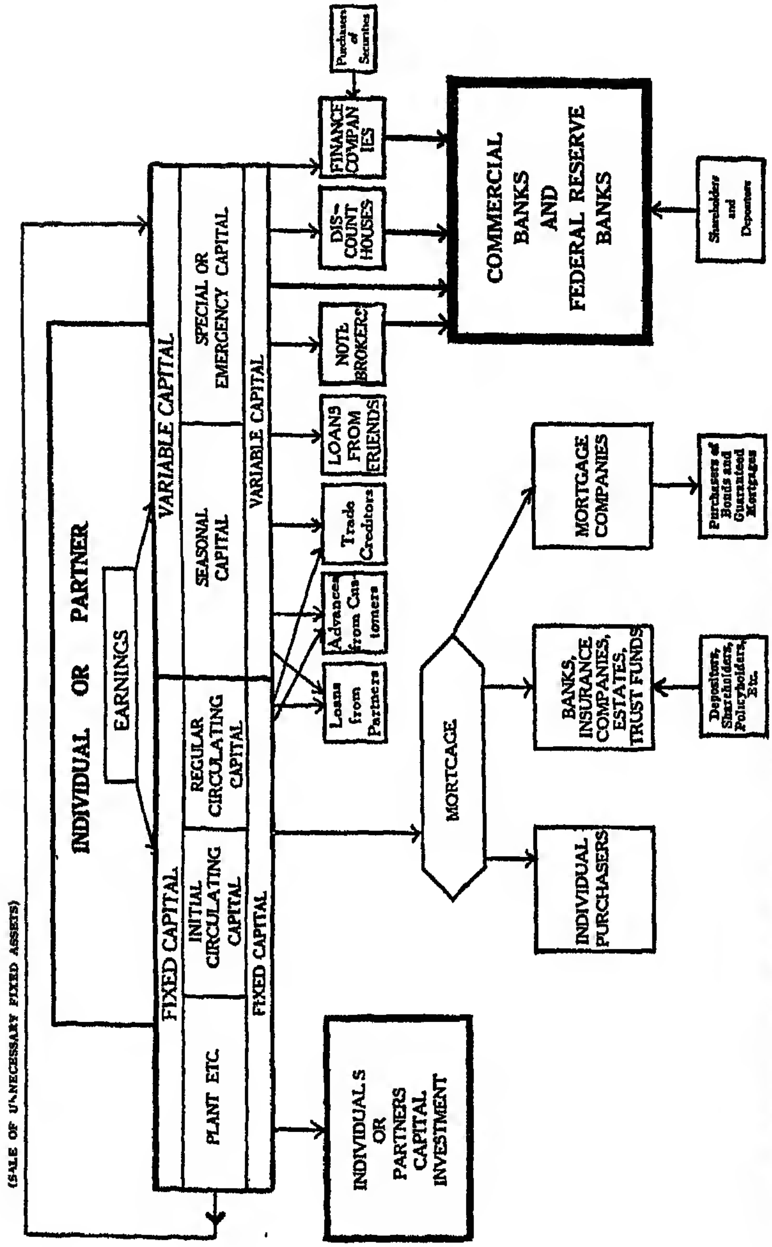
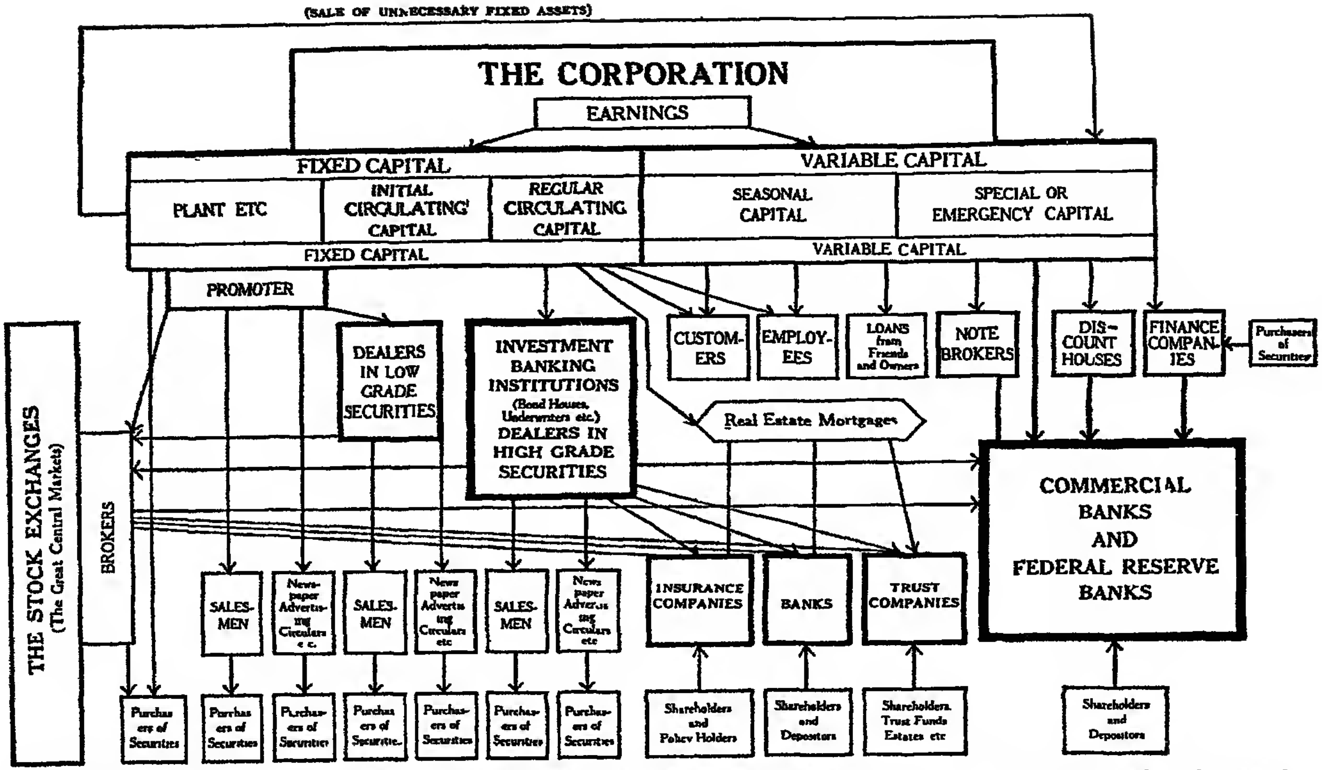
[26] Instances may be cited of companies finding it advantageous to conduct their own sales campaign The Milwaukee Electric Railway and Light Co once succeeded in selling $3,600,000 of its own bonds at a total selling expense of $73,771 82 (about 2 per cent), whereas it would have cost the company $144,000 if the issue had been underwritten at 4 per cent, or $189,000 if underwritten at 5 per cent. See other illustrations on pages 351 and 377.



Adapted by permission from a similar chart in H G Moulton, "The Financial Organization of Society"

Sources To Which Businesses Organized Without Negotiable Shares May Look For Funds
(See Also Chart of Circulating Capital, Page 440)



Adapted by permission from a similar chart in H G Moulton, "The Financial Organization of Society" To meet recent practice, a line should be drawn from Fixed Capital directly to Insurance Companies See page 367

Sources To Which Corporations, Massachusetts Trusts, and Joint Stock Companies May Look For Funds
(See Also Chart of Circulating Capital, Page 445)

were promised positions on the selling staff of the company when its product was ready to be marketed The regular assignment of territories and of district managerships in connection with the sale of the company's product depended upon success in selling the securities. The same plan has since been used by other concerns. As has already been pointed out, this method is expensive. In one carefully and energetically managed case which the author had occasion to observe rather closely, where a total of $1,000,000 was raised, the cost ran to between 25 per cent and 33⅓ per cent of the money received. The indefiniteness of the statement of cost was due to the fact that officers of the company gave part of their time to selling securities and part to other businesses. Moreover, it was difficult to allocate exactly such costs as rent, stationery, and the like.

During 1921, the H. H. Franklin Co. sold stock by means of circulars and salesmen at a cost of about 5 per cent. The vice-president claimed that a sale through the organized channels of security distribution would have cost from 7 to 15 per cent.[27]

Subsidiaries to aid investors in acquiring securities.—Before 1933, several large public utility companies which were interested in having a wide distribution of their securities among customers, employees, and the public found it expedient to have a separate organization to assist investors in purchasing the corporation's securities. Thus, the American Telephone & Telegraph Co. formed a subsidiary company, the Bell Telephone Securities Co., principally for the purpose of advising and aiding investors who were interested in purchasing securities of the Bell system in the open market. The Cities Service Corporation had its own security selling organization in Henry L. Doherty & Co.[28] The financial disaster experienced by many holding companies in 1930, the liabilities imposed under the Securities Act of 1933, the control of securities markets through the Securities Exchange Act of 1934, and the provisions of the Public Utility Holding Company Act of 1935 have resulted in elimination of most of the security selling subsidiaries. The General Utility Securities, Inc., which was affiliated with the Associated Gas &

[27] *Commerce and Finance*, June 14, 1922, page 872.

[28] Bell Telephone Securities Co was dissolved in 1936; Henry L Doherty & Co. went out of business in 1933.

Electric System as a securities distributing organization before 1933, has continued as a dealer in the securities of the System.

Selling securities direct.—If a corporation does not operate through an investment banker but undertakes, through necessity or choice, to market its own securities, its success in disposing of the issue will depend not only on the security itself but on the ability of the seller to convince prospective buyers of the advisability of purchasing.[29] The experience of the public with fraudulent promotion has been so unfortunate that to be selling securities through channels used by the fraudulent concerns is a severe handicap to the legitimate company. The fact is that the ordinary investor is not able to distinguish between the legitimate and the fraudulent enterprise. Both may avail themselves, like the banker, of prospectuses, periodical advertisements, explanatory circulars, and sales staffs. Nevertheless, the technique and content of their respective appeals are sufficiently different to enable the careful investor to distinguish readily one type from the other.

The main arguments for and against direct selling are set forth in an article describing the experience of the H. H. Franklin Co., referred to on page 376 [30]

For a corporation successfully to sell its securities directly to the public, as the H H. Franklin Co of Syracuse has recently succeeded in doing, is

[29] The Securities and Exchange Commission reported that approximately 9 per cent of the securities registered between Jan 1, 1936 and June 30, 1938 were to be distributed by the issuers themselves, 76 per cent were underwritten and 15 per cent were to be sold through agents (S E C Statistical Series, Release No 276) Studies made by the Securities and Exchange Commission show the difficulties which promotional ventures have in raising funds without banking assistance In only one out of every twenty promotional ventures is the new issue underwritten One analysis showed that in 40 per cent of the total number of issues for which registration under the Securities Act was effective and for which no underwriting was indicated, not one share of stock or one bond was sold within the year following the effective date of the registration statement, of the total amount effectively registered, only 20 per cent was actually sold within a year The expenses of distribution in such cases average about 10 to 15 per cent of the amount contributed by the investors Furthermore, such large amounts of securities are issued to the promoters that it is estimated that promoters receive about ten times as much as the public for an equal dollar of investment See Gourrich, "Investment Banking Methods Prior to and since the Securities Act of 1933," 4 *Law and Contemporary Problems* 44, 53 (1937)

[30] "A Non-Stop Route in Stock Selling," by Edwin Dakin, *Commerce and Finance*, June 14, 1922, pages 871–2 Certain practices mentioned in the article would be modified, of course, if direct selling were undertaken today

a feat almost unparalleled in finance The W L. Douglas Shoe Co did it, but this company was aided by the fact that Douglas had been governor of Massachusetts, was widely known, and had an enormous personal following Other companies have tried it—notably the Pennsylvania Railroad, some years ago—and failed The H H. Franklin Co —and the Douglas Shoe Co. —stand almost alone . . .

In 1919 the Franklin company, when they decided to fill the need for expansion and additional capital by selling $5,000,000 of stock, tabled the middleman idea. The direct-to-consumer plan in marketing securities had its dangers as well as its advantages, but its advantages were alluring

It meant eliminating the middleman's profits and getting cheaper capital, if the plan succeeded at all Cheaper capital meant cheaper production It meant, also, the possibility of placing a small amount of stock in the hands of each of a large number of small investors, rather than permitting a few speculators to control large blocks of stock which would come back and forth on the market and fluctuate constantly Small investors are usually permanent investors

These were the advantages There were also real dangers to be faced Suppose the stock were put on the market, advertised, heralded—and no one would buy The Franklin company would not only be left holding the bag—they would suffer a serious loss of prestige. Such an eventuality is always carefully considered by any house of first purchase that intends to market an issue of securities under its own name Long before the securities are ever advertised it sends out salesmen to test the market, if the market isn't responsive the securities are not advertised On the other hand, when the sale of a group of securities eventually is announced, the list has already been largely, sometimes almost wholly, subscribed Thus is prestige carefully protected The Franklin company, without using middleman machinery, was not in a position to test the road beforehand. It would have to travel largely on faith.

Faith, daring, or perhaps a combination of the two, was at hand It was frankly an adventure . . .

Perhaps one of the main reasons why the Pennsylvania Railroad failed in the same sort of project was that the public generally was not, strictly speaking, a Pennsylvania rooter Public goodwill has lately come to be recognized as a Gibraltar asset

The Franklin company employed salesmen; but salesmen were not sent out first. The real stress was put on advertising, not only in newspapers, but by circulars Franklin car owners were circularized, of course, so were a selected list of other prospects Salesmen were used simply to follow up the circularizing campaign and reap in the sheaves

To date the Franklin company has sold about $6,500,000 worth of stock in this way, to approximately seven thousand shareholders. This is an average subscription of about $1,000 The total number of Franklin car owners is about 40,000, with only owner-subscribers, therefore, the average would be one in every six. The average, naturally, is not this high; allowance must be made for other investors The fact remains, however, that less than half a dozen banks and other so-called large investors are on the list. .

From the beginning, the Franklin company recognized one important necessity. It was true that the small investors were not of the speculating

class, there would not be a constant turn-over of securities always bobbing up on the market, to fluctuate there; most small stockholders, true to type, would normally hold on like leeches But with small security holders there is one great danger—they are more easily panic-stricken, perhaps, than any other class Like the traditional flock of sheep they will go browsing along in perfect peace and happiness until suddenly, without warning and for no real reason at all, they will sniff the air, shake their tails, and fly scooting off in fear into the dim distance. And the value of the securities of course disappears with them

There was one way to prevent this for the Franklin company to act as a point of contact between people who found it necessary or otherwise decided to sell, and people who wanted to buy Of course no stockholder could be told that any time he wanted to sell, the Franklin company would buy his holdings at par Such an action comes under the law preventing a corporation offering to one stockholder the privilege that is not extended to all But to every new buyer of securities was sent a letter urging that if he ever desired to convert his stock, it should be offered through the company before being otherwise offered for sale

By this means a par market has been maintained on Franklin Preferred since it was first sold During the trying period of 1921, when many stocks were depressed to a fraction of their normal values, Franklin stood firm at $100 a share And less than $100,000 of a total issue of $5,000,000 came on the market during the entire year. . . .

There is one thing in which we have been especially fortunate—we have not aroused any resentment among the bankers We have taken no definite steps to avoid this—there was, in fact, nothing that we could really do to guard against it The credit here, perhaps, should go to the bankers

What attitude would be taken by bankers if such a direct system of security placing were generally adopted is of course a matter for guesswork. In an isolated instance it affects them little enough. Then, too, such a practice would not work universally—not, perhaps, for even the majority of flotations Most securities, like politicians and actresses, need special press agents—they don't place themselves. Certainly, banks needn't think of going out of the security business for a long time.

In the twenties some of the large utilities had exceptional success in selling securities directly to the public. For example, in 1922 the New York Telephone Company announced that 107,000 persons applied for shares of the company's issue of $25,000,000 par value 6½ per cent preferred stock. The total applications amounted to $82,500,-000. In this case the employees of the company were the only selling agents and were allowed commission of 1 per cent. The official statement said:

More than 70 per cent of the applications were for ten shares or less and more than 60 per cent, or 63,148 applications, were for five shares or less. There were 24,609 applications for the maximum allotment of twenty shares, representing $49,218,000.

It has been necessary to scale down the allotments and notices will be sent to applicants within the next six days. The basis of allotment is as follows Applications for one and two shares, allotment, 1 share; 3 to 8 shares, 2 shares, 9 to 15 shares, 3 shares, 16 to 18 shares, inclusive, 4 shares; 19 and 20 shares, inclusive, 5 shares

The main purpose of our offer was to secure a wide distribution of the stock among our subscribers, particularly among persons who ordinarily are unable to invest their savings in high-grade securities We made it possible for subscribers to secure the stock on one payment or on small monthly payments, and the response shows that the opportunity was very generally recognized

We have reached people who, in the aggregate, have an enormous buying power and who, when fairly dealt with, will support their public utilities both in the ordinary conduct of the business and by investing in their securities

The prospectus.—Where a corporation is offering its own securities, the piece of literature used to describe the issue and the company back of it is called a prospectus. Under the Securities Act of 1933, the term "prospectus" is applied to any notice, circular, advertisement, or letter written or broadcast which offers a security for sale. As indicated on page 359, the issuance of a prospectus that conforms with the requirements of the Securities Act of 1933 is compulsory in connection with the public offering of securities. The purpose of requiring a prospectus is to secure for potential buyers the means of understanding the nature of the securities which they are invited to buy [31] The information required to be shown in the prospectus is practically the same as that included in the registration statement, except that under rules issued by the Commission certain information contained in the registration statement may be omitted from the

[31] The required prospectus is so formidable a document that, in the opinion of some people, the investor gets less understandable information than formerly To make it easier for the investor to understand the offering, the "newspaper prospectus" was introduced This is a one-page summary of the issue, the issuer, and the underwriters' commissions. This type of prospectus usually appears as an advertisement in the newspapers and as the first page of the required prospectus See illustration on page 382 The newspaper prospectus invariably contains some such statement as the following, to meet the exacting requirements of the Securities Act of 1933. "This is not an Offering Prospectus The Offer of this Preferred Stock is made only by means of the Offering Prospectus This issue, though registered, is not approved or disapproved by the Securities and Exchange Commission, which does not pass on the merits of any registered securities" The advertisement will also frequently indicate that further information is contained in the Registration Statement on file with the Securities and Exchange Commission, and in the Offering Prospectus which must be furnished to each purchaser and is obtainable from any of the firms whose names appear in the advertisement

prospectus. The corporation, however, must file with the prospectus a complete reconciliation and tie-up of all data shown in the prospectus with the data shown in the registration statement. Civil and criminal liabilities are imposed for false statements of material facts or omission to state a material fact necessary to make the statements not misleading.

Space does not permit the inclusion here of a complete prospectus; some run as long as one hundred pages. Nor can we show in detail the nature of the material required to be included in the prospectus. The following table of contents of the thirty-nine-page prospectus issued in connection with the $50,000,000 issue of Firestone Tire & Rubber Company Ten-Year 3½ per cent Debentures gives some idea of the information contained in the prospectus. On the following pages is a reproduction of the first page of the prospectus.

History and Business
- General Character of the Business
- Sales and Distribution
- Manufacturing
- Raw Materials
- Research and Development Work
- Recent Additions to Plants and Properties
- Properties and Businesses Recently Disposed of
- Labor Relations
- Litigation
- General

Property
Results of Operations
Management
Debt and Capitalization
Application of Proceeds
Underwriters
Terms of Offering
Legal Opinion
Description of Debentures.
- Certain Definitions
- Redemption Provisions
- Sinking Fund Provisions
- Covenants Regarding Dividends, etc.
- Covenants Regarding Indebtedness, etc.
- Certain Default Provisions
- Information Concerning the Trustee
- Modification of the Indenture
- Pennsylvania Tax Refund

Historical Financial Information
Employment of Experts
Certificate of Independent Public Accountants
Financial Statements and Schedules.
- Index
- The Company
- Tho Company and Subsidiary Companies Consolidated

Additional Information Contained in the Registration Statement

PROSPECTUS

$50,000,000

THE FIRESTONE TIRE & RUBBER COMPANY

TEN-YEAR 3½% DEBENTURES

Dated October 1, 1938 Due October 1, 1948

Coupon Debentures in denomination of $1,000, registerable as to principal Interest payable semi-annually April 1 and October 1 Principal and interest payable in Cleveland, Ohio, or at the holder's option in New York City.

Certain Pennsylvania taxes with respect to the Debentures, as set forth on page 23, are refundable, upon proper application, in an amount not exceeding in any year five mills on each dollar of the taxed value of any Debenture

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The Debentures are subject to redemption at the option of the Company as a whole or in part by lot at any time, or through the Sinking Funds on any interest date, upon not less than 30 days' published notice if redemption be made on any interest date, and upon not less than 45 days' published notice if made on a date other than an interest date, at a redemption price equal to 103% of the principal thereof if redeemed on or before October 1, 1941, or 102% of such principal if redeemed thereafter and on or before October 1, 1944, or 101% of such principal if redeemed thereafter and on or before October 1, 1947, or 100% of such principal if redeemed thereafter, together in each case with accrued interest on such principal to the date of redemption

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The indenture provides for a Fixed Minimum Sinking Fund to retire, by October 1, 1939, and by each October 1 thereafter, $1,500,000 principal amount of Debentures The Indenture also provides for an Additional Earnings Sinking Fund to retire, by April 1, 1940, and by each April 1 thereafter, either $1,200,000 principal amount of Debentures or such lesser amount as may be retired through the application of a sum equivalent to 20% of the Consolidated Net Income for the preceding fiscal year. To the extent that retirements through the Additional Earnings Sinking Fund are less than $1,200,000 in any year, such deficiency is to accumulate and is payable in subsequent years as described herein The Additional Earnings Sinking Fund may be credited with Debentures redeemed other than through the Sinking Funds Sinking Fund payments may be made in cash or Debentures

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THESE SECURITIES HAVE NOT BEEN APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION

The Firestone Tire & Rubber Company has registered the securities by filing certain information with the Commission The Commission has not passed on the merits of any securities registered with it

IT IS A CRIMINAL OFFENSE TO REPRESENT THAT THE COMMISSION HAS APPROVED THESE SECURITIES OR HAS MADE ANY FINDING THAT THE STATEMENTS IN THIS PROSPECTUS OR IN THE REGISTRATION STATEMENT ARE CORRECT

	Price to Public	Underwriting Discounts or Commissions	Proceeds to Company
Total	$49,750,000*	$1,250,000	$48,500,000*
Per Unit	99½%*	2½%	97%*

* Accrued interest to be added.

The Company has agreed, upon request of Brown Harriman & Co, Incorporated, and Otis & Co (Incorporated), to make application to list the Ten-Year 3½ % Debentures on the New York Stock Exchange

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These Debentures are offered subject to prior sale and when, as and if issued and accepted by the Underwriters, and subject to the approval of Davis Polk Wardwell Gardiner & Reed, counsel for the Underwriters, and to certain further conditions The validity of the Debentures has been passed upon by Bernard M Robinson, General Counsel for the Company Certain other matters will be passed upon for the Underwriters by Shearman & Sterling It is expected that delivery of the Debentures in temporary form, exchangeable for definitive Debentures when prepared, will be made at the office of Brown Harriman & Co, Incorporated, 63 Wall Street, New York, N Y, on or about October 31, 1938, against payment therefor in New York funds

As more fully set forth on page 10 of this Prospectus, certain of the Underwriters have authorized the purchase and sale, in the open market or otherwise, of Debentures for their several accounts, either for long or short account, within the limits and during the period set forth in the Agreement between themselves

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The list of Underwriters set forth on pages 13 and 14 hereof includes

Brown Harriman & Co Incorporated		Otis & Co (Incorporated)
Halsey, Stuart & Co. Inc.	Blyth & Co, Inc.	Lehman Brothers
The First Boston Corporation	Lazard Frères & Co.	Glore, Forgan & Co

The date of this Prospectus is October 26, 1938

Methods of bygone days.—It might be interesting here to note the methods of direct sale that prevailed early in the last century. Promotion then, about 1830, was mainly concerned with the building of railroads, and capital was subscribed for at meetings called by the managers of the enterprise for the purpose of interesting leading citizens of the community. Petitions were usually sent to the legislature to induce the State to purchase a block of shares or to grant a subsidy. Thus, an announcement in the prospectus of the Albany and Susquehanna, R. R., 1852, reads: "The Directors of the Albany and Susquehanna R. R. Company propose holding the following series of meetings for the purpose of recommending this important enterprise to the favorable consideration of the people of the counties of Schoharie, Otsego, Delaware, Chenango and Broome." It was not unusual for the salesmen to solicit subscriptions by a house to house canvass. In this way the Pennsylvania R. R. at one time obtained 2,600 subscriptions, of which 1900 were for five shares or less. Even the influence of the pulpit was utilized to encourage investment in early railroad securities.[32]

[32] See Cleveland and Powell, "Railroad Promotion and Capitalization," especially Chapter XI.

Telephone selling.—Today the telephone is employed occasionally in the sale of legitimate securities, but its use by the seller of fraudulent issues has become part of a clever scheme to induce purchase by a prospect chosen at random from the columns of the classified directory. The dealer calls up his chosen victim and if accorded even a courteous hearing, telephones again and again, each time giving warning of an impending increase in the price of the security. He actually raises the original quotation and then has a colleague call upon the prospect to buy at a higher figure the stock which this accomplice pretends to believe the prospect already holds. Shortly after this, the first salesman again offers his stock and the dupe, falsely secure in the belief that he has a ready purchaser at a higher price, is tricked into parting with his money.

"Earmarks" of security frauds.—The medium most commonly used by the "fake promoter" is sales literature, and here the "earmarks" of fraud are many and unmistakable. The promoter, having obtained his mailing list from some speculative concern that is willing to sell the names of its stockholders, or from some firm which makes a business of selling stockholders' lists,[33] or having built up a "sucker list" through an "inquiry department" in his own financial paper, more appropriately called a "tipster sheet,"[34] sends out colorful literature that is devoid of accurate and specific information. Actual misrepresentation of facts is studiously avoided for fear of legal prosecution. The literature consists largely of expressions of opinions and arguments by analogy. It

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[33] The fact that buying and selling stockholders' lists has become a recognized business is evident from the provision in the New York Stock Corporation Law which provides that the corporation may with impunity deny access to a stockholders' list to a shareholder who shall have, within the previous two years, sold such a list for any purpose

[34] The "tipster sheet" has been used freely in recent years to defraud the public This sheet highly recommends some one particular issue that the promoter wishes to sell In order to conceal the real purpose of the publication, information is also included on well-known securities The tips given in the sheets are followed up by telephone and telegraph See "Gold Bricks in New Wrappers," by Harry W Riehl, General Manager of Better Business Bureau, St. Louis, Mo , in the *American Bankers Association Journal*, November, 1927, for schemes used in defrauding the public This article lists the following "types of fraud" and explains some of them: bucket shop, boiler room, blind pool, tipster sheet, merger, fractional share scheme, switching, reloading, one-call system, the telephone razz, the tap system, puts and calls, stockholders' committees, dynamiting

contains unsupported and over-sanguine estimates of future profits instead of a true balance sheet and profit and loss statement [35]

Quick and large profits on a small initial investment are the usual bait. The promoter who guarantees dividends or promises the prospect that he can get his money back at any time should be avoided as a vendor of valueless securities. The nominal price of the stock he offers may be high, but as a rule it is low. Appeal is usually made to the poor, who are generally the most gullible. A share may sell for as low as ten cents because the purchaser is being "let in on the ground floor," so the promoter explains, "and unless the purchase is made immediately the opportunity of a lifetime will be lost."[36] This hurry-hurry call is too often effective.

Equally suspicious is excessive emphasis upon the presence among the board of directors, or in the list of stockholders, of the name of a single individual prominent in public life. Such a man may possibly be the tool or even the victim of unscrupulous promoters.[37] When the name of an unknown corporation is noticeably similar to that of an established concern, careful investigation should be made. The promoters of a "Ford Tractor Company," for example, purposely took into their organization an individual by the name of Ford in order to furnish a legal excuse for their assumption of the name.

Readiness of promoters to give credit for worthless securities is suspicious. Their intention usually is to obtain an additional cash payment and to return papers as valueless as the ones they accept. Their willingness to take good securities in payment should suggest wariness to the prospective purchaser. This practice became such a menance after the war that the government warned investors in Liberty bonds to beware of the glib salesman who was willing to accept government bonds in return for untested issues. The sell-and-switch

[35] A study of registration statements filed by metal mining corporations, which did not become effective, shows that the assets in the balance sheets were largely fictitious and represented mere bookkeeping entries See Edward G Cale, "A Study of Ineffective Issues," 4 *Law and Contemporary Problems* 32 (1937)

[36] See C. W Gerstenberg, "Materials of Corporation Finance," page 386.

[37] However, it should be said that the appearance of the names of several reputable men with irreproachable records, as directors and officers, must be considered a recommendation At any rate, they furnish a source from which the prospective investor ought to be able to get concrete information

appeal is a steady standby of stock swindlers, especially when well-known securities are depreciated.

The characteristics which have been described also mark the newspaper and periodical advertisements of securities of fraudulent promotions. Such publicity is confined, as a rule, to small newspapers and magazines, for reputable publications refuse to accept financial advertising which by its copy and appearance smacks of fraud. An inquiry brings to the prospect a flood of circulars, newspapers, lengthy letters, "heart-to-heart" appeals, and even telegrams. By inducing the purchase of absolutely worthless securities, such methods have mulcted the public of an amount in excess of a billion dollars annually, a loss which post-office regulations, and the efforts of the Better Business Bureaus and of the State Securities Commissions, have proved inadequate to prevent.

Effect of Securities Act of 1933 on security frauds.—The Securities Act of 1933 has undoubtedly prevented the distribution of millions of dollars of worthless securities. In 1935 the Securities and Exchange Commission established its securities-violations files, for which it has steadily assembled information relating to security frauds. The Commission cooperates with the Post Office Department, the Federal Bureau of Investigation, the State securities commissions, Better Business Bureaus, and other agencies in gathering and disseminating information. The Commission thus serves as a clearing house for information on security frauds.[38]

That the Act and the efforts of the Commission have not wiped out fraudulent promotions is clear from the fact that the Commission has litigated numerous cases involving the use of fraudulent devices. Prosecution by the Department of Justice has resulted in the imposition of fines and prison terms No matter how much progress is made toward controlling the distribution of fraudulent securities by refusal to permit unsatisfactory registration statements to become effective, by the issuance of stop orders, by the prosecution of individuals under the Act, and by vigorous campaigns against persons defrauding the public, there will always be need for the individual investor to look for the earmarks of fraud in low-grade securities.

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[38] See Jay W Blum, "The Federal Securities Act, 1933-36," 46 *Journal of Political Economy* 52.

Chapter XXII

UNDERWRITING, SYNDICATING, AND DISTRIBUTING SECURITIES

Definition of underwriting.—Although the term "underwriting" originated in the practice of English merchants, gathered in Lloyd's famous coffee house, of writing their names at the end of certain documents wherein each agreed to assume jointly with the others a portion of the risks of marine and other hazardous enterprises, the practice commonly called "syndicate underwriting of corporate securities" probably originated in France. A very clear definition of a *true underwriting* agreement is to be found in an English case in which the learned judge said "An underwriting agreement means an agreement entered into before the shares are brought before the public that in the event of the public not taking up the whole of them or the number mentioned in the agreement, the underwriter will, for an agreed commission, take an allotment of such part of the shares as the public has not applied for."[1]

This definition remains accurate, but today the term is more comprehensive and is used to designate not only an underwriting in the defined sense but also the relationships between an issuer and a person (a) who purchases an issue outright with a view to reselling and distributing it, or (b) who sells *for* the issuer in connection with any such distribution.[2] In the discussion which follows the word will be employed in each of these meanings.

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[1] *Ex parte* Audain, 42 Ch D. 1, page 6 See also London Paris Financial, etc , Corp , 13 Times L R 569

The *London Economist* in 1873 (Vol XXXI, p 994) defined an underwriting syndicate to be "an association of persons who guarantee the subscription to the issue either wholly or partially, each guarantor usually accepting the responsibility for so much to the actual contractors "

[2] The Securities Act of 1933 defines an underwriter as follows "The term 'underwriter' means any person who has purchased from an issuer with a view to, or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking, but such term shall not include a person whose interest

Definition of syndicate.—The word *syndicate* stands for a form of business organization known technically as a "joint adventure." Syndicates in general are temporary associations of firms formed for the purpose of carrying through a given object; usually they terminate automatically when that object has been accomplished. In the security business, a syndicate is an association of "houses," formed by one or more dealers who will nominally act as manager or managers of the group, for the purpose of underwriting or distributing an issue pursuant to the terms of appropriate underwriting or selling agreements.[3] The members of a syndicate are usually called "participants."

Before attempting to explain the purposes and processes of underwriting and distributing securities, let us look briefly into the history of investment banking in this country.

Historical review of investment banking.—Five definite epochs are discernible in a broad historical review of American methods of marketing securities. The periods and their dominant characteristics are described briefly below.

Pre-Civil War.—In the early part of this period there were few issuers and few investors. Business concerns and merchants in need of capital sold their securities directly to investing institutions and to wealthy individuals, without the aid of an investment banker. When funds were needed for local improvement projects, for example, shares were offered directly to the public at some tavern or other public meeting place, where the subscription books were opened. The purchasers appeared in person and their subscriptions were entered in the books. Brokers sometimes assisted in the distribution of these securities by purchasing "blocks" of the offerings for their own accounts and reselling them to clients. Although the stock exchanges were organized in this period, the investment banking machinery was as yet undeveloped. In the period around the 1830's, commercial

is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission As used in this paragraph the term 'issuer' shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer." Sec. 2 (11)

[3] This definition recognizes the common use of the term "syndicate" in connection with selling groups The selling group, which is not a syndicate in the strict sense of the word, performs some of the functions of the selling syndicates that existed in the twenties, and is therefore loosely referred to as a "syndicate" by those in the investment banking field. See page 406.

banks performed some of the functions of investment bankers by purchasing large blocks of State and municipal securities and by making loans to promoters with stocks and bonds as collateral.

Foreign bankers were active during this period in purchasing State bonds and securities of American business enterprises to an extent which varied as wars abroad, resumptions of peace, and economic crises in this country affected their interests. Many of these foreign houses established American branches, while others maintained "connections" here.

The panic of 1837 caused great losses to the banks, cut off the flow of capital from abroad, and undoubtedly retarded the development of investment banking It led States to seek a separation of investment banking from commercial banking, and brought about a tendency to leave real estate financing to separate institutions. Toward the close of this period, speculation in railroad and miscellaneous securities began to grow.

Post-Civil War.—The Federal Government's need for funds and its inability to raise them in foreign capitals because of the unpopularity of the Union cause abroad led to the formation in 1871 of a syndicate of investment bankers, under the leadership of Jay Cooke, to place $2,000,000,000 of Government bonds. In the opinion of some authorities,[4] this was the first example of underwriting in America. It was about the year 1875 that the process of syndicate underwriting of securities became well known to the financiers of England and America.

Cooke's success in selling bonds in small amounts to tradesmen, laborers, farmers, and other small investors by

[4] See F A Cleveland, "Promotion and Capitalization of Railroads," page 287 Professor Cleveland says that Jay Cooke applied the French method of underwriting securities to the government's bond issue of 1871, and that this was the first example of underwriting in the United States It is submitted that when Stephen Girard (a Frenchman, to be sure) rescued the country from bankruptcy by taking $5,000,000 of United States bonds sixty years before 1871, he in effect acted as an underwriter It might reasonably be objected that before Girard took the bonds, a public offer had been made and that the failure of the public to subscribe for more than $20,000 worth of the securities precluded anything but an out-and-out purchase A house cannot be insured after it has burned down. But the answer is that the house, though previously in danger, had not burned down When Girard subscribed to the extent of $5,000,000, he assured to the Government the sale of its bonds, not ultimately to himself (for he did not have that much money), but through him to the public

appealing to their patriotism and national pride developed the small investor's interest in securities. Later, during the period of wild speculation that occurred, many of these purchasers of Government bonds became speculators in stocks and bonds of new railroad corporations. They, as well as many investment banking houses, were caught in the panic of 1873, which abruptly terminated the period of speculation. Some of the railroads which had been financed by investment bankers failed as a result of the panic. The public generally became wary of the security-selling methods that had been employed and remained timid in respect to the securities markets for many years thereafter.

Pre-World War and World War.—In the early part of this period the American capital markets narrowed. Individual investors placed their funds directly in business enterprises or in real estate and permitted banks and insurance companies to act as their investing institutions. International banking houses dominated the field through their close connections with domestic investing organizations. Up to about 1910, the practice of underwriting the sale of securities was apparently more widely followed in England than in America.

The emphasis in this period was upon the underwriting and wholesaling of securities rather than upon retailing. Thus, when the panic of 1903 occurred, it was attributed largely to "undigested" securities. The Armstrong Committee, appointed by the New York State Legislature in 1905, with Charles Evans Hughes at its head, delved into the practices of insurance companies in the underwriting field and revealed conditions that finally resulted in legislation prohibiting insurance companies from engaging in underwriting.

The period from 1893 to 1914 marked an era of reorganization and consolidation of railroads and of consolidation of many small industrial plants into large co-ordinated units. The United States Steel Corporation, the American Can Company, the International Harvester Company, and many others of the country's largest industrial corporations were organized in this period. The investment banking business developed as the bankers assisted in effecting the absorption of vast amounts of public utility and industrial securities that came into the market. Speculation and fraud became

rife with the expansion of public interest in financing. Some of the inflation of values caused by this activity was squeezed out during the panic of 1907. As the need for checking fraudulent sales of securities was felt, "blue sky" laws began to appear in various States.

The World War and the impetus it gave to the expansion of American industry led to the absorption at home of a great bulk of American securities that had until then been held by investors abroad. Many foreign loans, as well as a large volume of new domestic loans, were floated.

Post-World War.—The period of investment banking that began with the World War ended with the enactment of the Securities Act of 1933. In this period, as in the post-Civil War period, the domestic capital markets were greatly developed. Not only had the Liberty Loan campaigns awakened public interest in investment of private funds in securities, but other factors, such as bank credit inflation and the development of high-pressure security salesmanship, contributed to bringing about an era of speculation that culminated in the crash of November, 1929 and subsided with the subsequent decline of prices. The complicated processes of underwriting and distributing securities that were created and matured during this period will be referred to from time to time in this chapter.

Syndication machinery was geared up during the twenties for speedy distribution of securities. Frequently the marketing of a new issue began on the same day that bankers signed the contract with the issuing corporation Thus, both the underwriters and the retailers avoided the risks of price changes. In many instances such great reliance was placed upon the judgment of the investment bankers in the selection of a new issue that the distributors and the buyers themselves paid little attention to the quality of the securities offered. Frequently the information available with regard to an issue was so meager that security analysts and buyers who wanted to study the quality of the security had no authentic data on which to base a considered judgment.

In 1932 the Senate Committee on Banking and Currency was authorized to investigate security dealings, banking practices, and their effects. During the progress of the investigation, Congress enacted the Banking Act of 1933, the Securities Act of 1933, and the Securities Exchange Act

of 1934, all of which had important effects upon investment banking in the next era. Many of the abuses disclosed by the Congressional investigation were completely forbidden, and other practices were stringently curbed.

Current period.—A vital change took place in the investment banking business, beginning with the enactment of Federal legislation to protect investors and to control securities markets. Not only were the processes of underwriting, syndication, and distribution of securities adjusted to the conditions created by the Securities Act of 1933 and the Securities Exchange Act of 1934, and to rules and regulations subsequently issued by the Securities and Exchange Commission, but the very organization of the investment banking houses and retail distributors was changed. At the beginning of the period, the number of investment banking houses which could undertake large risks was considerably cut down, as compared with the twenties. This reduction was due principally to three factors: (1) the losses sustained in unmarketable securities during the deflationary period caused the failure of a number of investment banking houses, reduced the capital of others, and induced still others to merge; (2) the Banking Act of 1933 eliminated bank security affiliates which in the twenties had handled many security flotations; (3) the fact that the Banking Act of 1933 does not permit private bankers to engage in security wholesaling and retailing. While some of the private bankers, like Kuhn, Loeb and Company, abandoned the deposit banking business to remain in the security wholesaling business, others, like J. P. Morgan and Company, withdrew from the securities business. However, as the capital markets improved somewhat, the number of investment bankers and their resources increased.

During the thirties, retail organizations became fewer in number and smaller in size, as compared with those of the twenties, because the public no longer clamored for securities. Some retail houses revised their organizations to serve the insurance companies and the financial institutions, which became the principal investors in bonds.

Private placing of loans increased,[5] and issues suitable for investment by financial institutions dominated the field. Undoubtedly the easy money policy of the Federal Reserve System, as well as the lack of demand for new capital, depressed the

[5] See page 367

yield on high-grade bonds, a factor which helped to reduce the already lessened interest of the private individual in securities

The investment banking mechanism which will be described in this chapter reflects the situation prevalent after six years of operation under the Securities Act of 1933. For two years after the passage of the Act, there was little or no corporate financing with the aid of investment bankers. The following four years constituted a period in the course of which the mechanism of security underwriting and distribution was adjusted to situations created by legislation and to the changed economic and financial conditions of the country. Some of the processes to be described here will undoubtedly undergo revision in the future as amendments to existing legislation are enacted and as new interpretations of the laws are rendered Furthermore, changes in the nature of the money market itself may bring about changes in investment banking methods and machinery.

Purposes of underwriting.—Underwriting—used in its broadest meaning—may be resorted to in corporate practice to assure the accomplishment of any one of many operations connected with corporate financing. The following are the usual purposes of underwriting:

1. Underwriting may assure the *sale of securities* that are issued for the purpose of raising funds for expansion purposes.

2. Underwriting may assure the *refunding of securities*. Thus, if bonds are about to become due, a new issue based on a mortgage of the same properties may be offered to the old bondholders. Since the indenture of the maturing obligation almost always calls for payment in cash, some of the holders of the bonds coming due may insist upon receiving such cash. In anticipation of such a contingency, the corporation may make a contract with investment bankers each of whom, for a designated consideration, usually covenants to purchase a pro rata part of the bonds of those holders who insist upon cash. The syndicate formed by the bankers then exchanges these bonds for the new issue. Generally, however, if the company wishes to refund an issue of bonds, it will sell the entire new issue to the investment bankers, and with the proceeds redeem the matured bonds, rather than offer the new securities directly to the old bondholders [6]

[6] During the "easy money" period following 1933, most of the bonds and preferred stocks sold were for refunding purposes.

3. The promotion of *consolidations* under what is termed the option method may be underwritten. The work of such a syndicate is described in the chapter on consolidation.[7]

4. Underwriting syndicates have long served in connection with the *reorganization* of corporations. Today the usual arrangement is for the underwriters to agree to purchase any of the new securities offered to existing security holders and claimants under an approved plan of reorganization but not subscribed for by them. The function of the underwriting syndicate in reorganization proceedings is discussed more fully on page 792

5. *Extension of maturity* of an outstanding bond issue may be underwritten.

6. *Exchange* of one form of security for another may be underwritten. For example, the exchange of debentures for mortgage bonds.

7 *Simplification* of public utility holding companies under Section 11 of the Public Utility Holding Company Act of 1935 may involve the raising of funds with the aid of underwriters.

8. In the past, underwriting served the purpose of assisting in the *conversion of securities*, for example, the conversion of 7 per cent preferred stock into 5 per cent bonds Since the holders of the stock could not be forced to make the conversion, the object of the underwriters was to buy the stock at a low price in order to offer it in exchange for the bonds.[8]

Kinds of Syndicates.—Syndicates are used less extensively at present than they were in the twenties. The various kinds of syndicates that are formed today and those that existed in the twenties are described below.

Underwriting syndicates are formed solely to assure the sale of an issue of securities that has been offered to old security holders. The syndicate does not purchase the securities from the issuing corporation, nor does it offer the securities to the public at the time of its formation. It merely agrees, for a stipulated payment, to purchase securities not taken by the old security holders The offering of the

[7] See page 651

[8] The classic example is the United States Steel Corporation's so-called bond conversion The story has been written in full by Professor Edward Sherwood Meade and should be studied by every student of corporation finance. See E S. Meade, "Trust Finance," and W. Z Ripley, "Trusts, Pools and Corporations"

underwritten securities to the shareholders may be made by the corporation. Since underwriting syndicates are formed in connection with issues that involve an offering to old security holders, they usually appear in issues of stock in which old stockholders have a preemptive right, and in issues created for refunding, conversion, consolidation, or reorganization purposes. The underwriting syndicate functions today in much the same manner as it did during the twenties and earlier.

Purchase syndicates.—The term "purchase syndicate" is applied to the group of investment bankers who purchase an issue of securities from the issuer. The composition of the group and its functions are described in detail on pages 404 *et seq*.

Selling or distributing syndicates—In the twenties there were in the field of retailing two outstanding syndicates, the distributing syndicate and the selling syndicate, each formed to obtain a wide sale of securities to the public They were organized by an underwriting syndicate to distribute the securities not taken by old shareholders, or by bankers who had purchased an issue of securities outright from a corporation. With the enactment of the Securities Act of 1933 the distributing and selling syndicates disappeared. The selling group, which was not and is not a syndicate in the strict sense of the term, survived [9]

Occasionally an issuer arranges for a group of bankers to act as a *distributing syndicate*. The actual offering of the security is made by the issuer as principal through the syndicate members as agents. The participants assume no liability and are compensated for their successful efforts in securing purchasers.

Loan syndicates were sometimes organized separately from, but supplementary to, underwriting syndicates to provide cash for corporations while their securities were in process of sale. These syndicates supplied cash to underwriting syndicates which were not able to sell their securities at the rate agreed upon with the corporation.[10] This function is now

[9] See footnote 18, page 406

[10] Frequently, delays occurred in getting the selling campaign under way; in such cases the necessity for supplying cash through loans did not reflect adversely on the marketability of the security. Loans were generally made by the banks to whoever could post the securities as collateral The hypothecated securities were then released as they were required for delivery to investors

performed by commercial banks which lend money to the corporation for limited periods until the funds are made available by the investment bankers.

Trading syndicates, or *pools*, as they are sometimes called, were formed to advance or maintain the price of securities. They frequently had no definite organization beyond the fact that a single manager engaged the services of a number of brokers to make purchases and sales. Such syndicates or pools today would come within the category of manipulative operations which are prohibited by the Securities Exchange Act of 1934. They are not to be confused with the trading account used by an underwriting group for permissible stabilization of prices. See page 427.

Classification of investment banking transactions.—Financing with the aid of investment bankers can be divided into two classes:[11] (1) financing in which the corporation offers its securities to old security holders but calls upon a group of bankers to underwrite the issue, (2) financing in which the corporation does not offer its securities to old security holders but sells the entire issue of stock, bonds, or notes to a group of investment bankers.

The functions of the bankers in each case are threefold: (1) to assure the corporation that it will receive payment for the securities at a certain price and by a certain time; (2) to provide funds which are to be paid to the corporation at the time payment is due; (3) to distribute the securities in such a way that after they have all been sold and the bankers are no longer involved in the marketing of the issue, the securities will have a natural market.

In accomplishing these purposes, the banking houses that deal with the corporation take the risk of not finding investors to purchase all of the issue at the public offering price and of being forced to hold the unsold securities to which they have title, since they paid the corporation for them on the closing date. This is the risk for which they are paid. (See discussion of compensation on page 432.)

Outline of two classes of financing.—To simplify the explanation, the fundamentals of each of the two classes of financing will be discussed first, as outlined below.

[11] A third class, that in which the group acts as agents for the issuing corporation in selling to the public, may be mentioned See page 395.

1. Syndication where offer of securities to old security holders is underwritten.
    a. Underwriting agreement with the corporation.
    b. Underwriting syndicate agreement among the bankers.
    c. Distribution of securities not taken by old security holders.
2. Syndication where securities are sold directly to investment bankers.
    a. Current methods.
    b. Methods followed during the twenties.
    c. Contract between the corporation and the purchasing bankers.
    d. Agreement among the purchase group underwriters.
    e. The selling machinery.

This discussion will be followed by an explanation of certain clauses in the various agreements, certain activities in the syndication process, and other matters, as described on page 425.

Usual method of syndication where deal involves offer to old security holders.—A complete underwriting of an issue which is to be offered to old security holders usually involves two agreements: (1) an underwriting agreement between the corporation and the banker that originates the issue, that is, the banking firm with which the corporation first deals, acting as representative on behalf of itself and the other "several" underwriters named in the agreement, and (2) the syndicate agreement between the manager, that is, the representative or the originating banker, and the participants. While some of the covenants of the agreements are different today from those used before the enactment of the Securities Act of 1933, the agreements are substantially the same as those of underwritings in the twenties.

Terms of underwriting agreement with the corporation.—A typical agreement between an originating banker on behalf of the participants and the prospective issuer usually takes the form of an exchange of letters. The terms of the agreement, of course, depend on the nature of the transaction to be entered into and the purposes to be accomplished. The following are the provisions commonly found in a true underwriting agreement, that is, one in which the syndicate is bound to take such securities as are left after an offer has been made to old security holders by the corporation:

1. *Purpose of the agreement*—The opening paragraph indicates that the corporation proposes to offer a certain number of shares of stock at a designated price to stockholders of record on a given date on the basis of one share for a certain number of shares held by each of such stockholders on the record date. The desire of the corporation to obtain agreements from underwriters to purchase those shares of stock which are not subscribed for by the stockholders during the subscription period is mentioned as the purpose of the contract.

2. *Representations and warranties of the corporation.*—The corporation generally warrants that it has prepared and filed a registration statement and prospectus with the Securities and Exchange Commission, and makes other warranties with respect to the completeness and accuracy of statements contained in the registration statement and prospectus.[12] It may also warrant that it will prepare and provide a newspaper prospectus.

3. *Agreement to sell unsubscribed stock, price.*—The corporation agrees to sell to the several underwriters named in the agreement, and the underwriters agree severally to purchase at the price at which the stock will be offered to stockholders, the respective percentages of unsubscribed stock set forth opposite their names. The percentages usually total 100 per cent of the unsubscribed portion of the stock.

4. *Payment for unsubscribed stock.*—Payment is to be made for the unsubscribed stock on a given date, although such payment may be deferred to a later time within a designated period, upon delivery of the stock to the head of the group for the accounts of the several underwriters. The corporation normally agrees to inform the banker within a prescribed number of days or hours of the number of shares of unsubscribed stock which each underwriter will be obligated to take up and pay for. The date and time for payment and delivery are known as the "closing" date.

5. *Compensation of underwriters.*—This subject is discussed on page 432.

6. *Offering of unsubscribed stock.*—The underwriters may or may not, as they determine, make a public offering of the

[12] The registration statement and exhibits are generally prepared by the attorneys of the corporation and reviewed by the underwriters and their counsel The prospectus is generally prepared from the registration statement by the underwriters and their counsel.

unsubscribed stock on the terms set forth in the registration statement. The corporation agrees to file any amendments or supplements to the registration statement necessary to facilitate such an offering, should the group decide to make one. The underwriters and dealers to or through whom the unsubscribed stock is to be sold are authorized to use the prospectus in connection with the offering. The corporation usually authorizes the underwriters to advertise the unsubscribed stock by means of any newspaper prospectus approved by the corporation.

7. *Conditions of underwriters' obligations*—The underwriters' obligations are subject to certain conditions These generally require that the registration statement be effective not later than a certain date, that no stop order shall have been issued, that counsel be satisfied with the legality of all matters pertaining to the issuance of the securities, and that there shall have been no material change in the corporation between the date of the agreement and the closing date. Other conditions may include the listing or preparation for listing of the securities by a certain time, the hedge clause described on page 426, and substantial performance by the corporation of its agreements under the contract.

8. *Other covenants of the corporation.*—The corporation agrees to perform certain obligations, which generally include the following: (a) to advise the originating banker when the registration statement and any amendments have become effective, and of the issuance of any stop order or the initiation of any stop order proceedings by the Securities and Exchange Commission; (b) to deliver a certain number of copies of the registration statement, and as many copies of the prospectus as the originating banker may reasonably request; (c) to furnish the principal underwriters with copies of any proposed amendments to the registration statement or prospectus before they are filed; (d) to keep the prospectus up to date for the period of one year after the date of the offering to the stockholders; (e) to qualify the stock for sale under the securities or "blue sky" laws of such States as the originating banker may designate;[18] (f) to indemnify the underwriters, as described on page 425.

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[18] The amount to be expended for qualification under "blue sky" laws is often limited Additional qualifications must then be paid for by the group.

9. *Date of agreement.*—The underwriting agreement usually becomes effective simultaneously with the registration statement, and until that time may be terminated, on written notice given as required in the agreement, by the company, by the manager, or by such number of underwriters as have in the aggregate agreed to purchase more than 50 per cent, or some other definite percentage, of the unsubscribed stock

10. *Reimbursement of underwriters upon cancellation.*—If the agreement is canceled by the underwriters for cause attributable to the corporation, any out-of-pocket expenses of the underwriters (including fees and disbursements of their counsel) reasonably incurred by them or any dealers in connection with the purchase or sale of the unsubscribed stock must be paid by the corporation.

Terms of syndicate underwriting agreement.—The originating banker offers a definite participation to various underwriters, selected in the manner described later in this chapter (see page 430). This offer is accepted or rejected, and of course may be changed by negotiation. The syndicate underwriting agreement brings together the original banker and the participants, confirms and completes the earlier preliminary understanding reached by telephone or letter, and recites the rights and obligations of the parties. The agreement takes the form of an offer addressed to the participants and accepted by them in a space provided for the signature.

In the first paragraph each underwriter confirms the arrangement made by the originating banker for underwriting the securities of the corporation. The letter then gives the terms of the agreement, the most important of which are:

1. *Authority to contract with corporation.*—Each underwriter authorizes the originating banker to execute on its behalf the agreement with the corporation, a copy of which is usually attached as an exhibit to the agreement among underwriters.

2. *Purchase of unsubscribed stock by the underwriters.*—The originating banker agrees to give each underwriter advice as to the number of shares of unsubscribed stock which he will be obligated to take up and pay for, and each underwriter agrees to inform the originating banker, within a specified period prior to the closing date, of the names and denominations in which it desires to have the stock registered. Each

underwriter agrees to pay the full purchase price upon delivery of the certificates to the originating banker. The compensation which the originating banker, who acts as manager of the syndicate, receives from the corporation on behalf of himself and the several underwriters is credited to the respective accounts of the underwriters.

3. *Restriction on trading in rights.*—Occasionally each underwriter is required to agree not to trade during the subscription period either in the rights of the corporation or in the stock for its own account.

4. *Compensation of manager.*—The compensation, if any, which the originating banker receives for negotiating, arranging, and managing the underwriting is indicated. Each underwriter agrees to pay, usually on the closing date, his share of the service fee, the amount of which is charged to his account by the manager.

5. *Distribution of unsubscribed stock.*—Until the termination of the agreement, each underwriter agrees to dispose of the shares in the manner and upon the terms and conditions provided in the agreement. He may not, without the consent of the manager, directly or indirectly offer for sale or participate in any offer for sale of the unsubscribed stock.[14] The underwriters authorize the manager to determine whether a public or any other kind of offering of the unsubscribed stock will be made, and at what offering price. The manager is further authorized to offer the unsubscribed stock to dealers, in its discretion, and to determine whether dealers shall be permitted to allow a concession to brokers or dealers actually engaged in the investment banking or securities business. The agreement as a rule indicates the maximum concession which may be allowed to dealers Each of the underwriters agrees that if all the securities are not sold and the manager deems it desirable to have the securities taken up by the participants, he may call upon them to "carry" their pro rata commitments. This subject is explained further on page 429.

6. *Liability of underwriters.*—The obligation of the underwriters to take up any of the unsubscribed stock that is not sold to others or that is reserved for dealers and not paid for

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[14] Often bankers are allowed to sell during the subscription period on a "subject to allotment" basis; then when they know how much unsubscribed stock they are going to have, they confirm their sales.

by them is clearly stated. The usual arrangement is described on page 430.

7 *Trading account.*—The manager's rights with respect to operating a trading account, its limitations in that respect, and the members' liability in regard to the trading account are set forth in the agreement. (See discussion of the trading account on page 426.)

8. *Repurchase clause.*—The agreement defines the rights of the manager with respect to the securities repurchased by it at or below the offering price for the trading account, and the obligations of the participants with respect thereto See page 428 for an explanation of the purpose of this clause.

9. *Expenses of the syndicate.*—Each underwriter agrees to permit the manager to charge his account with a proportionate share of all expenses incurred by the manager in connection with the underwriting of the sale of the stock by the corporation or the purchase, carrying, and sale of any unsubscribed stock. Taxes on transfers are not made proportionately, but are charged to the accounts of each underwriter in accordance with the number of transfers made for his account

10. *Termination of agreement.*—The date when the syndicate will expire, and the manager's rights with respect to extending or terminating the agreement, are defined See page 436.

11. *Effect of default.*—The default of any underwriter ordinarily does not release any of the other underwriters from their obligations. If an underwriter defaults, another may take his place or his participation may be assumed by some or all of the participants.

12. *Changes in registration statement.*—The manager is authorized to approve changes in the registration statement, prospectus, and newspaper prospectus. If the effectiveness of the agreement with the corporation is dependent upon the registration statement becoming effective on a certain date, the manager may be given the right—within limits—to extend that date.

13. *Rights and liabilities of manager.*—The manager is relieved from certain duties and liabilities, such as the duty to account for interest on funds of the underwriters in his hands, and liability for the form of or representations contained in the certificates of stock, subscription warrants,

and the like. The manager is liable for lack of good faith and for obligations expressly assumed by him in the agreement.

14 *Confirmation.*—Each underwriter confirms having examined the registration statement, prospectus, and amendments, and expresses his willingness to proceed with the underwriting of the sale.

15. *Indemnification*—The indemnification clauses described on page 424 are included

The relationship of the parties (see page 431), the fact that the liability of each underwriter is several and not joint, and the manner of giving notices required by the agreement are also covered in the agreement.

Usually all the underwriters meet, or are represented by attorneys, in the office of the head underwriter, where the agreements are signed

Distribution of securities not taken by old security holders.— If the amount of securities not taken by old security holders is small, each member of the syndicate may dispose of the shares at private sale, in the open market, or otherwise If the amount is large, a selling group of selected dealers may be formed to assist in the distribution of the shares The manner of arranging the group and its method of operation are described on pages 415 *et seq.*

Syndication where securities are sold directly to investment bankers.—In the preceding paragraphs we dealt with the underwriting of an issue of securities that is offered to old security holders, and explained in some detail the agreements involved in such a transaction. We shall now proceed with an explanation of underwriting effected by a sale of an entire issue of securities to a group of investment bankers. Since present-day methods vary considerably from practices followed in the twenties and are an outgrowth of the latter period, we shall briefly describe the methods of both periods before explaining the nature of the agreements usually involved in such underwriting today.

At the close of the detailed explanation of the entire procedure involved in underwriting the sale of an issue of securities to a group of investment bankers, a diagram of the process is presented. The serious reader, however, would do well at this point to turn immediately to the diagram on page 424 and examine it in a general way without trying definitely to understand it completely. Then, as each step is

discussed, he may again refer to the diagram to see the relation of the particular discussion to the entire process.

Current methods of purchase and distribution by investment bankers.—A deal involving the purchase of an issue of securities from a corporation originates in one of the following ways. (1) the corporation may approach an investment banking house with which it has had previous dealings or with which it desires to have dealings; (2) the investment banker may approach a corporation with a plan for recapitalization or other financing that is advantageous to the corporation; (3) a "finder" who makes a practice of bringing corporations and bankers into relationship with each other, and who receives a fee from the bankers if the deal is consummated, may recommend the business; (4) the investment banker may learn of the corporation's need for capital through a friendly bank, (5) the purchase may be secured through competitive bidding.

The house with which the corporation arranges the deal is said to originate the issue. It does most of the negotiating, investigating, and preparation of the issue. The originating banker usually sends invitations to other underwriting and investment houses to participate in a purchase group which will buy the entire issue from the corporation [15] Each invitation is accepted by the policy-determining committee of the house if after an examination of the proposed issue they decide that they wish to be associated with the financing [16] Otherwise it is rejected. Each member of the group, rather than the originating banker alone, assumes his share of the contractual liability with the issuing corporation.[16a] The

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[15] For the reasons stated on page 408, and because the underwriters, for tax reasons, do not wish to be deemed a unit—that is, an association or a partnership—the current tendency is to avoid the use of the word "group," to speak of the participants as underwriters, and to emphasize their status as several individuals. In this text, however, for convenience and simplicity, we have not avoided the use of the word "group"

[16] As a rule, the invited participants examine the affairs of the issuing corporation less thoroughly than the originating banker, but they examine carefully the reports of engineers, accountants' statements, and other material prepared by the technical staff of the originating house and by independent experts hired by the issuer Sometimes they send their own experts and engineers to examine the properties of the issuing corporation

[16a] In previous years security issues were frequently handled by two houses through a joint account In registered issues today, however, the joint account is avoided and the several liability of the participants is stressed

originating banker is generally authorized to act as a representative or manager of the purchase group. Occasionally, however, the originating banker will prefer to have some larger and better-known house act as manager.

Three agreements are usually made in the underwriting of an issue of securities through purchase by investment bankers: (1) an agreement between the corporation and the originating banker who acts as representative of all the underwriters participating in the purchase; (2) an agreement among the underwriters, in which the rights, duties, obligations, and liabilities of the several underwriters are defined, (3) an agreement among selected dealers, sometimes called a "selling group," who will aid the several underwriters in distributing the issue. These agreements will be described in detail later.

The agreement with the corporation usually provides that it shall become effective when the registration statement becomes effective.[17] At that time there is a firm commitment by the investment banking houses to pay for the securities they have previously agreed to purchase. About two or three days before the effective date of the registration statement, assuming that the offering is to take place as soon as practical after the registration becomes effective, the underwriters meet and negotiate all terms of the purchase agreement and of the selling group agreement not previously determined. At this time, the public offering price and the price to be paid to the company having been negotiated and agreed upon, the agreement among the underwriters is signed The contract with the corporation is generally signed later the same day by the representative of the several underwriters on behalf of each of the underwriters. Both of these agreements may be held in escrow until the conditions necessary to make the agreements effective have been met.

Methods of purchasing and distributing securities during the twenties.—During the twenties the preliminary steps in financing through the sale of securities to investment bankers were very much the same as those described in the preceding section. After negotiation and investigation by the originating banker, a contract was entered into between that banker and the corporation. This contract generally provided for the banker's firm commitment to purchase

[17] See page 426 for clause giving the underwriters the right to terminate the agreement before the delivery date

the entire issue, in the case of bonds and better-grade stocks. In the case of smaller and more speculative issues, the contract would provide for conditional purchase, or would give the banker an option to purchase, or would make the banker the selling agent of the corporation.

Once the contract had been signed, the corporation had practically no further interest in the syndicate process. The banker had on his hands the problems of dividing the risk assumed in purchasing the securities, of furnishing the funds to the corporation, and of distributing the securities widely, while at the same time placing them so permanently that they would not drop in market price when the banker withdrew from the marketing process. To accomplish this there were certain methods available to the banker, a choice of which depended upon two elements: (1) the amount of the spread between the purchase price and the price at which it was expected the securities would be sold to the public, which determined how much the banker was willing to give up for the sake of distributing the risk; and (2) the difficulty anticipated in the sale of the securities.

Assuming (a) that the issue was second grade, (b) that the spread between the purchase price and the offering price was fairly large, (c) that the issue was of good size, and (d) that it would not, in Wall Street slang, "go out the window" but would have to be sold throughout the country by many dealers if it were to be well assimilated, the banker would usually organize the following groups: a purchase group, a banking group, and a selling syndicate. Each of these groups actually would purchase all or part of the issue from the preceding group at a price somewhat higher than that paid by the group from which it made its purchase. If the issue were second grade, of small size, and one that the banker did not anticipate having great difficulty in selling, he would organize a purchase group, a special group, a banking group, and, instead of a selling syndicate,[18] a selling group or whole-

[18] The principal difference between a selling syndicate of the twenties and a selling group, as it was organized in the twenties and as it exists today, lies in the nature of the participation of the members, and consequently in their liabilities. The selling syndicate ordinarily purchased the entire issue from the banking group, and the members of the syndicate, which was made up of dealers and other distributors, accepted participations in the syndicate. The participations represented commitments for which each participant remained liable under a limited liability or unlimited liability account until

sale group. If the issue were "top" grade and likely to be sought by investors, and if the spread between the purchase price and the offering price was small, the bankers would form only a purchase group, a banking group, and a selling group.[19]

The names of the groups varied from banking house to banking house. What one firm called a purchase group another would call a buying group; what one house termed a distributing group another would term a selling group, what one firm labeled a selling syndicate, another would label a distributing syndicate. We shall not explain here the functions, rights, and liabilities of the various groups named, since to do so would merely be to review a complicated process no longer followed.[20]

Preliminary explanation of agreements in purchase of security issue by investment bankers.—As indicated on page 405, three agreements are generally made in the underwriting of an issue of securities through purchase by investment bankers. In order to understand the agreements, it is necessary to know, first, why the underwriters deal directly with the corporation through a representative. Second, it must be understood that part of the commitment underwritten by several underwriters is almost always given up for sale to a group of selected dealers, part is often sold through the manager to institutions under what is termed a "group sale," and the remainder is retained by the underwriters to be distributed through their own retail selling organizations.

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all the securities were sold to the public Under the unlimited liability arrangement, if any of the underwritten securities to be sold by the syndicate were left unsold, each participant in the syndicate was required to take his proportionate share of the unsold securities, based on the proportion which his participation bore to the whole issue This was also called an "undivided account" Under the limited liability syndicate, or "divided account," a participant was required to take only the difference between the amount of his participation and the amount which he had sold Members of the selling group, on the other hand, were and are today liable only for the amount of securities which they purchase, and they have no interest in the securities purchased by other members of the group.

[19] Toward the close of the twenties, the trend was toward elimination of the selling syndicate and exclusive use of the selling group Furthermore, with the narrowing of the spread in underwriters' profits, fewer intermediary groups were being formed Thus, many believe that simplification of the syndication process was developing before the Securities Act of 1933 became effective

[20] The functions and organization of the various groups are described in detail in the 1932 revised edition of this book

This aspect of syndication is clearly shown in the diagram on page 424.

We shall explain why each underwriter deals directly with the corporation, how part of the commitment is given up for members of the selling group, and what is meant by "group sales" before we discuss the agreements proper.

Why the underwriters deal directly with the corporation.—The practice of having the entire group of underwriters, whether it consists of a few houses or a hundred houses, enter into a contract directly with the corporation, through the representative banker, to purchase the securities is due to the desire on the part of the underwriters to limit their civil liability and to distribute the liability of the commitment immediately. A brief explanation of these two reasons will clarify the practice.

Under the Securities Act of 1933, each underwriter is subject to civil liability for untrue statements of a material fact in a registration statement, omission of material facts required to be included, and omissions of material facts necessary to make the statements not misleading. The statute states that any person acquiring a security issued under a defective registration statement may sue every underwriter for the consideration paid for the security plus interest thereon, less the amount of any income received thereon, if the purchaser tenders the security, or for damages if he no longer owns the security By entering into a purchase agreement with the corporation to acquire a portion of the issue, each underwriter limits his liability to the total price at which the securities underwritten by it were offered to the public, with adjustments for interest and income, as noted; in other words, each underwriter is liable only for the portion of the issue which it has underwritten.

The Act provides that no offering of corporate securities can be made until the registration statement has become effective. Under the present law, at least twenty days must elapse after the filing of the statement before it can become effective.[21] In practice, where the offering is to take place

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[21] This compulsory waiting period between the time of filing the statement and the time when the securities may be sold gives the Securities and Exchange Commission an opportunity to make an examination to determine whether or not the required disclosures have been made The waiting period was also intended to eliminate many of the abuses connected with high-pressure sales-

immediately upon effectiveness of the registration statement, the price information relating to the underwriting contracts is filed with the Securities and Exchange Commission between the seventeenth and the nineteenth day after the original filing. If the contract were made between one banker and the corporation, as formerly, that banker alone would bear the total liability during the period between the signing of the contract and the effective date, since he would not be allowed to share his liability by distributing the securities before the effective date. Therefore, in order to divide the liability during the period between the signing of the contract and the offering date, and thereafter, all the underwriters contract directly with the corporation through the representative.

The give-up for selected dealers.—While each underwriter agrees to purchase a certain portion of the new issue, it also authorizes the manager, or representative of the group, to withhold all or part of its participation for sale to and distribution by the members of the selling group. Ordinarily, this give-up is computed on a percentage basis For example, 40 per cent of its participation may be taken for this purpose from each of the underwriters. Sometimes the give-up is computed on a sliding scale; that is, underwriters over \$1,000,000 give up 50 per cent; those over \$500,000 but less than \$1,000,000 give up 40 per cent, those between \$200,000 and \$499,000 give up 20 per cent, and those under \$200,000 give up 15 per cent. Adjustments may be made and some underwriters may retain all their bonds.

In determining what part shall be withheld, the manager often takes into consideration, among other things, the distributing ability of the participant. For example, one of the participants may have underwritten a larger portion of the issue than the manager feels it can distribute. In that case, a larger proportion will be taken away from that underwriter than from the others.

As we shall see on page 419, a certain commission is paid to each member of the selling group for the securities which it agrees to purchase. Thus, part of the gross spread

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manship, such as inadequate opportunity to examine the essential facts of an issue. The failure of the waiting period to reduce the pressure in distribution is described on page 417.

between the purchase price paid by the purchase group and the offering price is consumed in dealers' commissions. If an underwriter takes any of the securities as a member of the selling group, he, of course, is entitled to the dealers' commission.

Group sales.—The representative, on behalf of each of the several underwriters, sometimes negotiates with large institutional buyers to sell to them for the respective accounts of the underwriters a certain amount of the issue directly. In such instances, the manager takes a pro rata share of each underwriter's participation for the group sale to such institutions at the public offering price. The reason for this practice is that institutional buyers usually make large purchases, and it is more convenient for them to deal with one house, that is, the representative of the underwriters, than to deal directly with each of the underwriters separately. This does not mean, however, that the institutions in this way get as much of an issue as they intend to purchase. The group sale merely assures them of getting a certain block of the securities from the underwriters at the offering price. Additional amounts must be obtained from the dealers in the usual way. Obviously, dealers would not be content to be excluded from making sales to these institutions. Furthermore, the institutions themselves wish to continue making purchases from many dealers.

Agreements involved in purchase and distribution of security issues by investment bankers.—We are now ready to examine two of the agreements that are generally involved in the purchase and distribution of an issue of securities by investment bankers. We shall discuss (1) the contract between the corporation and the purchasing bankers; and (2) the agreement among the underwriters. The agreement among selected dealers, or selling group agreement, will be treated in connection with the discussion of the selling machinery, at page 418.

Terms of contract between the corporation and the purchasing bankers.—Since the terms of the contract depend upon the nature of the financing—that is, upon whether the issue arises through a recapitalization of the company, through a sale of one corporation to another and the issuance by the new corporation of certain classes of securities, through the creation of new classes of stock in an existing corporation,

or through an increase of bonded indebtedness—the contracts vary in form to meet the particular situation. In this discussion a contract for the sale of an issue of preferred stock by a corporation to a group of bankers will be described.

The agreement between the corporation and the purchasing bankers parallels the underwriting agreement between the corporation and the bankers in a transaction which involves an offer of securities to old security holders. In fact, many of the provisions of the contract between the corporation and the purchasing bankers are so similar to those contained in the underwriting agreement explained at pages 397 *et seq* that only the provisions substantially different from those in the agreement previously described will be given in detail The similar provisions are as follows. (1) representations and warranties of the issuer (see page 398), (2) conditions of the underwriters' obligations (see page 399), (3) covenants of the corporation (see page 399); and (4) reimbursement of underwriters upon cancellation (see page 400)

The contract takes the form of a letter from the corporation to the underwriters, which in the opening paragraph confirms the agreement to sell a certain number of shares of stock to the underwriters. The most important terms of the agreement, in addition to provisions referred to in the preceding paragraph, are as follows:

1. *Statement of the amount of purchase, price, closing date, and time of offering to dealers.*—The names of the underwriters are given and the number of shares each agrees to purchase is placed opposite each underwriter's name. The obligation of the underwriters is confirmed to be several. The amount of money to be received by the corporation is indicated, together with the date when delivery of the shares is to be made to the underwriters and the payment therefor is to be made by the underwriters. A certain number of days after the effective date may be mentioned as the latest closing date. The manner in which payment is to be made and the form in which the securities are to be issued are prescribed. The name of the manager of the underwriters is stated. The intention, if any, to form a selling group is also indicated. The manager is sometimes required to give the company notice of the time when invitations are mailed or telegraphed to dealers who are expected to become members of the selling group. The

agreement indicates that the manager shall determine the date when such invitations are to be sent to dealers.

2. *Costs, expenses, and counsel fees.*—The corporation usually agrees to pay all costs, charges, and expenses incident to the performance of its obligations under the agreement, and the fees and disbursements of accountants and other experts in connection with the preparation of the registration statement and prospectus. Occasionally it covenants to reimburse the underwriters for the fees and disbursements of their counsel.

3. *Financial statements.*—The corporation agrees to make available to the underwriters (some agreements say to the stockholders as well) a consolidated balance sheet, consolidated earnings statement, and consolidated surplus account annually or semi-annually.

4. *Effect of failure of underwriters to purchase stock.*—The agreement provides that if any of the underwriters shall fail or refuse, for any reason permitted in the contract, to purchase the securities agreed to be taken by them, the remaining underwriters shall have the right, with the consent of the corporation, to take up the portion not taken, or substitute another underwriter or underwriters. In the event that the remaining underwriters do not take up the stock or substitute an underwriter, the agreement is canceled and the corporation must reimburse the underwriters as indicated in item 2 The corporation may, however, institute legal proceedings for damages against any underwriter who fails to keep its agreement

5. *Notices*—Provision is made as to the manner of addressing the corporation and the underwriters in giving any notices required by the agreement.

6. *Parties benefited.*—The agreement sets forth that it is for the benefit of the underwriters, controlling persons, and the corporation, and not for the benefit of any third party whatsoever.

Terms of agreement among underwriters.—As indicated on page 410, in addition to the contract between the corporation and the purchasing bankers, there is also an agreement among the underwriters. This agreement brings the participants in the purchase group together in much the same way as the syndicate underwriting agreement, described on pages 400 *et seq.*, brings together the underwriters in a trans-

action which involves an offer of securities to old security holders. In fact, many of the provisions noted below will be recognized as similar to those contained in the agreement described on pages 400 *et seq.*

The agreement among the underwriters usually takes the form of a printed letter setting forth in simple language the powers and obligations of the participants and of the manager or representative. For purposes of explaining the terms of the agreement, we shall take as an example an agreement involving the purchase by investment bankers of an issue of debentures. The opening paragraph confirms the agreements of the underwriters with the manager with respect to the purchase by the manager and the underwriters of a certain issue of debentures designated by name and total amount. The letter then proceeds to give the terms of the agreement, the most important of which are as follows:

1. *Registration statement and prospectus*.—The participants acknowledge the filing of the registration statement and the advance receipt of the registration statement and the prospectus as they have been originally filed, and of the proposed newspaper prospectus.

2. *Authorization and compensation of manager*.—The manager is authorized to act on behalf of the underwriters in the agreement among underwriters, and to be manager of the selling group proposed to be formed in connection with the securities. The compensation of the manager is specified. It may amount to anywhere from $\frac{1}{8}$ to $\frac{3}{8}$ of 1 per cent of the principal amount of the debentures purchased by each participant. Sometimes no compensation is provided.

3. *Offering of securities*.—The manager is authorized to offer the securities on any date determined by him, not later than that specified in the agreement, at the initial public offering price indicated. Reference is made to the organization of a selling group and possibly to the group offering, if any. The manager is given the right to select the dealers to be invited to become members of the selling group, and to determine the respective amounts of securities to be offered to such dealers, and the terms of the selling group agreement.

4. *Subunderwriting*.—The right of any of the participants to enter into a subunderwriting agreement may be set forth. (See explanation of this provision on page 422.)

5. *Give-up; liability.*—The manager's right to determine the amount of securities which each underwriter will retain and the amount which each will give up for the selling group is noted, as well as the terms under which the participants may sell the securities retained by them The underwriters agree to be bound by the terms of the selected dealers agreement in selling the securities during the life of such agreement. The liability of each of the participants in the event that all of the securities offered to the selling group are not paid for by them is stated. (See discussion of liability on page 431.) The limitations upon the participants' right to trade in the securities for their own accounts may be set forth.

6. *Repurchase clause*—The manager is given certain rights with respect to the securities repurchased by it below the public offering price The obligations of the participants with respect thereto are indicated See page 428 for an explanation of the repurchase clause.

7. *Trading among participants*—The underwriters and members of the selling group are sometimes given the right to buy and sell the securities among themselves, at the offering price less all or part of the selling group concession, after the selling group books have been closed.[22] Sometimes underwriters may trade with each other at the offering price less the full gross spread or any fraction thereof

8 *Payment.*—Each of the participants agrees to take up and pay for the securities to be purchased by it, at a certain time and in a designated manner. The manager is authorized to accept the securities from the corporation on behalf of the underwriters, and is directed to deliver to the participants the amount of securities not given up, and to remit payment by members of the selling group for securities sold by them for the account of the underwriters. The right of the manager to deliver securities for "carrying" purposes is also indicated. (See discussion on page 429.)

9. *Loans.*—The manager is authorized to make loans for the account of the underwriter in the event that the underwriter's payment for the securities purchased by it is not received in time. (See discussion of loans on page 429.)

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[22] "Closing" of the books means that no more bonds are available for purchase by selected dealers, and does not refer to termination of the agreements

10. *Advertising.*—Each participant is given the right to advertise over its own name and at its own expense after the original advertisement by the manager or shortly after the public offering date.

11. *Expenses.*—The manner in which expenses involved in the underwriting shall be met by the participants is clearly defined.

12. *Termination.*—The date when the agreement will expire and the manager's rights with respect to extension or prior termination of the life of the agreement are noted. (See page 436.)

13. *Termination by an underwriter.*—The effect of termination of the agreement by an underwriter and of the failure of an underwriter to perform its part of the agreement is shown. The default of any underwriter does not generally release any of the other underwriters from their obligations.

14. *Rights and liabilities of manager.*—The manager is given full authority to take such action as he may deem advisable in respect to all matters pertaining to the agreement, but is authorized to act only in the capacity of agent of the participants. Other specific rights of the manager may be set forth, such as the right to change the public offering price and to alter concessions and reallowance to dealers. The matters for which the manager is not responsible are also sometimes enumerated.

Other items in the contract pertain to (a) the agreement of the underwriters to comply with conditions set forth in the registration statement, (b) notices, (c) the manner in which the agreement among underwriters is being executed, (d) effect of confirmation, and the like.

The selling machinery.—We have already seen that the securities are to be distributed partly by the underwriters themselves, partly through the group sale to financial institutions, and partly by the selected dealers who are invited to join the selling group. Distribution by the underwriters requires no further explanation, and we have already discussed group sales. The discussion of the selling machinery which follows, therefore, deals with the organization and operation of the selling group.

Selection of selected dealers or selling group.—The object of the manager is to distribute the securities that are reserved for the selling group among dealers who are able to sell them

to permanent investors. To insure the desired distribution of the securities, the manager may call upon firms all over the country and occasionally even in foreign countries, if the issue is large enough and the issuing corporation is well-known, to sell the securities. He must build up an adaptable selling machine for each particular issue. Most managers keep records of past performances of dealers with whom they were previously associated, and with such records as guides, select the houses to which to make offers for participation in the distribution. Frequently a dealer hears about a deal either at the time of its registration or before and requests a selling group participation, if and when an issue is offered Among the selected dealers may be some of the very firms who have a participation in the purchase group. In that event, their rights and liabilities as members of the selling group will be entirely independent of their rights and liabilities as underwriters

The group which the manager forms is known as "selected dealers" or a "selling group," depending upon the terminology employed by the manager. The agreement under which they are brought together is generally called a "selected dealers agreement" or a "selling group agreement." The terms of this agreement are explained on pages 418 *et seq.*

Distributing information prior to the effective date of registration.—Although dealers may not be solicited to buy a security until a registration is effective, the manager, subsequent to the filing of a registration statement, but before its effective date, and just before the contract with the corporation has been signed, may send to the dealers whom it proposes to invite to participate in the selling group, a "red herring" prospectus and preliminary selling group agreement. The red herring prospectus is the preliminary prospectus, across the face of which is a red ink statement indicating that the information is given circulation for information purposes only; that it is subject to correction and change without notice; that under no circumstances is it to be considered as a prospectus or offer to sell or solicitation of an offer to buy the proposed securities described therein. The red herring statement goes on to state that "No offer to buy or sell such proposed securities should be made, and neither the Company nor any underwriter will accept any order to purchase such securities unless and until the Registration Statement filed under

the Securities Act of 1933, as amended, with respect to such securities has become effective Such offers should be made only on the basis of the authorized prospectus when, as, and if issued after the effective date of the Registration Statement."

A covering letter is often sent with these preliminary exhibits to the dealer, explaining that the manager plans to offer the securities when the registration statement is effective, as of a certain date; that a selling group will be formed; and that the dealer will probably be included in the group. The letter further informs the dealer that firm offers will be made, or that the offering will be on a subscription basis. The statement that no offering can be made until the offering date is repeated in this letter.

Mechanics of distribution to dealers.—To describe the mechanics of distribution to dealers, let us take the instance of an offering that is to be made the moment the registration statement becomes effective.[23] The final selling group agreement and prospectus are mailed to dealers at the earliest possible moment after the registration statement becomes effective. The manager also sends a telegram to the selected dealers, after the mailing of the prospectus and selling group agreement, containing an offer of a certain number of bonds or shares of stock, at the offering price, less the selected dealer commission. The telegram requests acceptance by the hour designated in the selling agreement. Until the actual acceptance takes place, there is no obligation on the part of the dealer to purchase any of the securities offered to him. If the dealer is not interested in acquiring any of the offered securities, he may ignore the invitation of the manager and permit the offer to lapse. Sometimes the dealer offers the securities to his customers before he answers the telegram, and then agrees to purchase from the manager that amount of securities which he has been able to distribute prior to the expiration of the offer.[24]

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[23] Many offerings are made several days or more after the twenty-day period has elapsed In such case delaying amendments are filed to keep the registration statement alive This procedure may be followed, for example, when the manager awaits a better market to begin his distribution The moment these amendments become effective, the offering is begun

[24] In view of the fact that the signing of the contract with the corporation may precede the effectiveness of the registration statement by only a few days, and that the effective date and distribution may take place almost simultaneously, it is clear that the registration requirements and the twenty-day waiting period have not slowed up the pressure in security selling

While most selling group agreements contain a statement to the effect that the dealer may enter his subscription for additional securities, subject to allotment by the manager, if the deal is a success the likelihood is that he will not be able to obtain more than was offered to him.

Formal acceptance of the offer to the dealer is made in writing by signing the selling group agreement, explained below, and returning it to the manager of the group.

"Beating the gun."—This expression describes the practice of selling, contracting to sell, or informally or orally promising to sell securities to a customer prior to the date stipulated for the public offering. The practice was known before the enactment of the Securities Act of 1933, and, it is claimed, has increased under the Act because of the twenty-day waiting or "cooling" period, during which "red herring" information is available to certain dealers. The financial institutions and dealers, for example, knowing that a certain issue has been registered and will be offered in a short time, may wish to purchase a certain amount of the offering, and will try to let their needs be known. Under the Securities Act of 1933 no offering or agreement to sell, and no offer to buy, can be made before the registration statement is in effect. Those who will be in a position to make the offer when the registration statement becomes effective may be hard put to follow the letter and spirit of the law in dealing with those who want to be sure to get the securities. They are always exceedingly careful to let prospective purchasers know that no offer can be made before the offering date.

Terms of agreement with selected dealers or selling group. As previously indicated, a preliminary selling group agreement is sent to the selected dealers prior to the effective date of registration, and a final selling group agreement is mailed after registration becomes effective and as soon as the public offering is to be made. The latter agreement is generally a four-page printed letter under the terms of which the dealers accept participation. An original and a duplicate copy of the final agreement are sent to each selected dealer. The duplicate copy is signed by the dealer and returned to the manager, the other copy, signed by the manager, is retained by the dealer for his files. In general, the selling group agreement is the same whether the dealers are to sell an issue of securities that was purchased from the corporation by a group

of underwriters, or to distribute unsubscribed stock which the underwriters have agreed to take after an offering had been made to stockholders. The following items generally constitute the agreement where an issue of bonds, for example, purchased by the purchase group, are to be sold through dealers:[25]

1. *Reference to agreement among underwriters.*—The opening paragraph indicates that the underwriters with whom the manager of the selling group is associated have severally agreed to purchase portions of the designated issue of bonds at a designated price, together aggregating the total issue. The name of the issue and that price are given. The dealer is referred to the enclosed copy of the prospectus for a complete description of the security.

2 *Dealers' commissions.*—The dealer is informed that the several underwriters are offering a part of the securities for sale, subject to the conditions of their purchase from the company, to a group of selected dealers at the public offering price less the selected dealers' commission of a certain percentage, say ¾ to 2 per cent (depending upon the gross spread), of the principal amount without deduction for any expenses.[26] The fact that any or all of the underwriters may be included in the group is noted, as well as the name of the company that will act as manager. The compensation of the manager may also be indicated

3. *Offer and method of acceptance.*—The dealer is advised that the selling group manager is reserving firm for purchase by him a certain principal amount of the bonds, subject to the conditions of the purchase by the underwriters and to the terms and conditions of the selling group agreement. The dealer must accept all or part of the offer by notifying the manager of his decision within a specific period. He is advised that he may subscribe to an additional amount, but the manager reserves the right to reject any or all subscriptions and to make allotments in his uncontrolled discretion. (See page 418.)

4. *Offer of bonds by dealer.*—The bonds may be offered for sale by the dealer immediately upon receipt of advice from the managers to the effect that the issue is released for

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[25] Many of the items included in the selling group letter represent practices which were inaugurated under the Investment Bankers Code. The Code died out when the National Recovery Act was declared unconstitutional.

[26] Sometimes expenses up to ⅛ or ¼ per cent are chargeable.

offering. The dealer is advised that members of the underwriting group have agreed to be governed by the terms of the selling group agreement in distributing that portion of their underwriting commitment retained by them for retail sales.

5. *Restrictions on resale price; concessions; purchase and sale among members of group.*—The dealer may not at any time prior to the termination of the selling agreement offer the securities for resale at a price below the public offering price. The only concession that may be allowed must come out of the selected dealers' commission, and it is limited to a definite amount, usually $\frac{1}{4}$ of 1 per cent. Such reallowance may be made only to brokers and dealers who are actually engaged in the investment banking or securities business.[26a] After the dealers are advised that all the securities have been sold and the books closed, they may purchase and sell the securities among themselves at the public offering price less the selected dealers' commission.

6. *Payment of dealers' commission.*—The commission to be allowed to dealers is payable to the dealer as soon as practicable after the termination of the selling group. If any of the bonds sold to dealers are repurchased by the manager in its open market operations, the manager may withhold the commission due for selling such bonds. See page 428.

7. *Remedies for default in payment of bonds.*—The remedies available to the manager in the event that the dealer defaults in payment for the securities accepted by him generally include. (1) the right to cancel all the dealer's rights under the agreement without demand, notice, or legal proceedings; (2) the right to sell any of the securities which the dealer is obligated to purchase at such price as the manager deems fair, and apply the proceeds to the defaulted obligation. The underwriters and the manager may be the purchasers of such securities without prejudice. The dealer remains liable to the underwriters for any losses resulting from his default, but default by one dealer does not relieve any of the other dealers from their respective obligations.

8. *Termination of group.*—The day when the selected dealer agreement will expire is indicated along with a state-

[26a] This limitation conforms with the rules of fair practice of the National Association of Securities Dealers, Inc., a national securities association registered with the Securities and Exchange Commission pursuant to Section 15A of the Securities Exchange Act of 1934, as amended

ment of the manager's right to extend its existence or to terminate it earlier.

9. *Advertising.*—A clause is sometimes added indicating when the securities will be advertised by the manager and the rights of members of the group to advertise the issue after the original advertisement has appeared.

10. *Registration statement and prospectus.*—The dealer is advised that a registration statement was filed. The fact that the issue is released for public offering is noted and the dealer is cautioned that he is not authorized to give any information or make any representations other than those contained in the enclosed prospectus An offer is made to supply copies of the prospectus on request.

11. *Authority of manager.*—The powers of the manager of the group are broadly stated. He is given full authority to take such action as he may deem advisable in respect to all matters pertaining to the group. He is authorized, however, to act only as agent for members of the group and for the underwriters. The matters for which the manager assumes no liability, such as the value of the securities, the validity of the form of the securities, and the like, are enumerated.

12 *Relationship of members of group.*—The dealers are advised that they are to act as principals, and may not act as agents for the several underwriters, when offering the bonds or otherwise fulfilling their agreement.

13. *Notices.*—The manner of giving notice is indicated.

14. *Form of acceptance.*—The dealer is asked to sign a form of acceptance which is included in the letter, even though he may previously have accepted by telephone or telegram. The letter may also contain a blank to be used when subscribing for additional securities. (See page 418.)

Price cutting.—One very important part of the agreement between distributors and managers is that which states that the offering price shall be maintained during the existence of the selling group. In violation of the agreement, some dealers may cut the price below the public offering price, allowing purchasers, in effect, part of their commission.[27]

[27] Dealers sometimes resort to such indirect methods of price cutting as "overtrading" and the "investment guaranteed" practice. In the former practice, the dealer may agree to accept as payment from purchasers of the new issue another security at a price above its actual, current market price. In the latter practice, the dealer sells the new securities below the public offer-

The only effective remedy the manager can impose upon a dealer guilty of price cutting is to exclude him from future selling groups.

Unsuccessful distribution.—If for any reason the deal is not successful and the underwriters find themselves left with a large part of the securities after the original offering has been terminated, they may form a new underwriting agreement among all or most of the underwriters to market the issue at a price lower than that originally determined. This will involve filing amendments to the registration statement and prospectus to show the new offering price and the new underwriting arrangements. A new selling group may also be formed to offer the securities at the lower price. If a subunderwriting had been arranged, the subunderwriters might be left holding the unsold securities.

Subunderwriting.—In order to distribute the risk in the event of unsuccessful distribution, the originating banker and the underwriters may decide, at the outset, that each of the underwriters shall have the right, with the consent of the manager of the purchase group, to arrange for a subunderwriting of all or a portion of its commitment. The underwriter agrees to pay to the subunderwriter part of the price spread to which the underwriter is entitled. For example, an underwriter with a commitment to purchase $1,000,000 of bonds may contract with another dealer, who may or may not be another underwriter, to subunderwrite that commitment to the extent of $500,000. This means that the underwriter may at any time call upon the subunderwriter to purchase on demand up to $500,000 of bonds. For assuming this risk, the subunderwriter may be paid ½ of one per cent It may be further provided that, in addition to the compensation noted, if actually called upon to purchase bonds from the underwriter, such bonds may be taken up at the public offering price less ¾ of one per cent. To illustrate, let us suppose that the above-mentioned underwriter is obliged to take up $700,000 of its commitment, the balance having been sold either directly or for its account by the representative. The subunderwriter may then be called upon to take up $500,-

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ing price to buyers who promise to retain the securities during the "penalty period," that is, the period during which the managers can repurchase the securities "penalty" at the full price or below. See page 428 for explanation of such repurchases

000 of bonds at the offering price less $\frac{3}{4}$ of one per cent. If, on the other hand, we suppose that the underwriter's unsold bonds amount to only $300,000, the underwriter may then, if it wishes, call upon the subunderwriter to take up the entire $300,000, at the offering price less $\frac{3}{4}$ of one per cent.

Occasionally one or two banking houses alone purchase an entire issue from the issuing corporation[23] and enter into contracts with a large number of other houses who agree to subunderwrite portions of the issue. In such a case the subunderwriters may receive substantial participations in the selling group at the time of offering, but their commitments in each group are entirely independent of their commitments in the other group.

This can be made clearer by an example. Let us assume that two houses purchase a $25,000,000 issue and invite fifteen houses to subunderwrite it. Subunderwriter *A* & Co. agrees to purchase on demand up to $1,000,000 of bonds at the public offering price. For this it is paid $\frac{3}{4}$ of one per cent on $1,000,000 In addition, and under a separate agreement, it receives a selling group participation of $750,000 of bonds. Neither of these amounts bears any relationship to the other. In any event, subunderwriters must agree to abide by the terms of the selected dealers agreement with respect to bonds which they acquire and offer for sale.

Diagram of syndication of a purchased issue of securities. In the preceding discussion, beginning with page 403, we explained the processes of syndication where a group of bankers purchase an issue of securities from a corporation and distribute them partly through a group of selected dealers, partly by a group sale, and partly by direct sale from the underwriters to the public. The diagram on page 424 depicts the processes described. The same diagram may be used to clarify the process where securities are sold by a corporation with the aid of bankers who underwrite an issue of securities offered to old security holders: merely place a box marked "Stockholders of a Certain Date" above the box entitled "Issuer," with a line showing an offer from the issuer to the stockholders. Another line marked "Unsubscribed Portion" should be shown leading from "Stockholders"

[23] Railroad securities, which are not subject to registration under the Securities Act of 1933, and which therefore do not involve the civil liabilities imposed by the Act, are often underwritten in this manner.

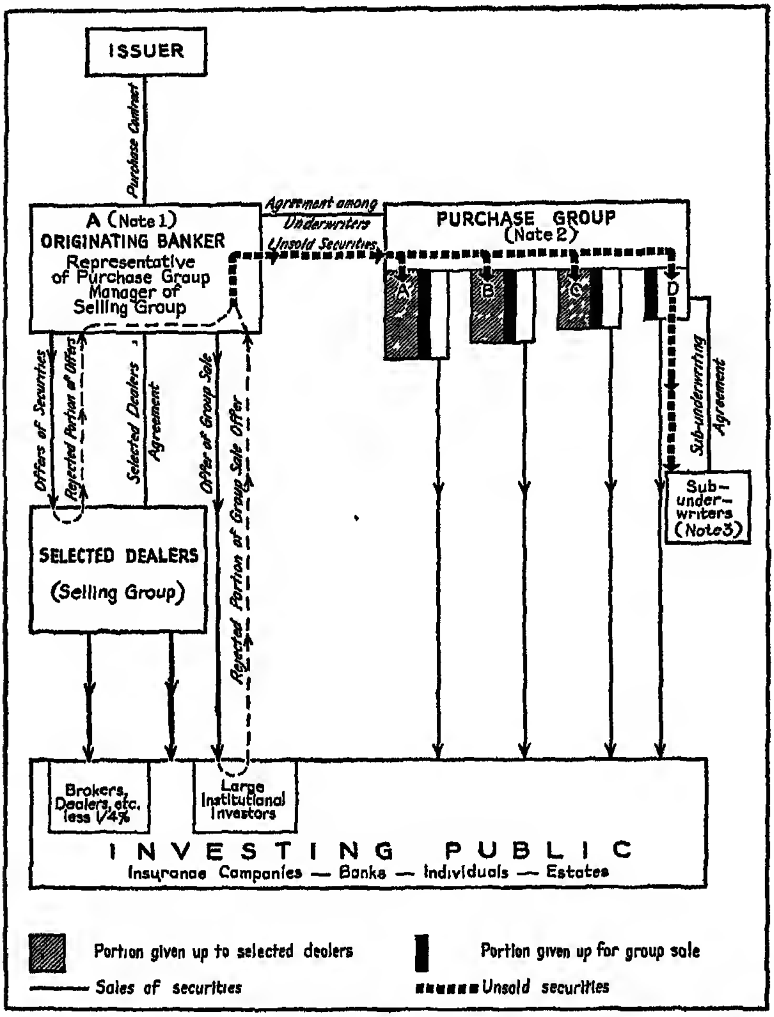

Chart Illustrating Syndication of an Issue of Securities Purchased by Investment Bankers

Notes (1) "A," originating banker, and "A" in the Purchase Group are the same

(2) The number of underwriters may be large (see pages 408 and 430); only four are shown in the diagram. The portion given up for sale by selected dealers may be smaller than is indicated in the chart, may be less for some underwriters than for others, and may be none at all, as shown for "D" (See page 409.)

(3) Any one or more of the underwriters may enter into subunderwriting agreements (see page 422)

to the box marked "A, Originating Banker," who is the representative of the participants.

Scope of following explanation.—In the preceding explanation of the processes of underwriting, we referred to certain clauses in the agreements and to certain activities in the syndication process without stopping to explain them. We also referred to the fact that the banking firm with which the corporation first deals acts as representative in behalf of the several underwriters or participants who underwrite an issue of securities which is to be offered to existing stockholders, or as representative in behalf of investment bankers participating in the purchase group when an issue of securities is sold directly to the bankers. In the remainder of this chapter we shall explain the clauses and activities referred to, and shall describe the manner in which participants are selected, their liabilities, compensation, and profits and losses. We shall also treat the powers, obligations, work, and compensation of the manager, the duration of syndicates, the advantages and disadvantages of syndicate underwriting, and competitive bidding.

Indemnification clauses.—The liabilities imposed upon the corporation, underwriters, and others by the Securities Act of 1933 for an untrue statement of a material fact contained in the registration statement, in the prospectus, or in the newspaper prospectus, and for an omission to state a material fact required to be stated therein, or necessary to make the statements therein not misleading, have led to certain clauses in the underwriting agreements designed to protect the various interested parties against losses, claims, damages, or liabilities arising out of actions based upon untrue statements and omissions for which they are not responsible. The indemnity provisions, which continue even after the underwriting agreements have terminated, generally consist of two parts. (1) indemnity of the underwriters; (2) indemnity by the underwriters.

Indemnity of the underwriters.—The corporation will usually agree to indemnify the underwriters, and each person, if any, who controls any underwriter within the meaning of the Securities Act of 1933, against claims, damage, and liabilities arising as described above, and to reimburse them for any reasonable legal or other expenses incurred by them in connection with defending against any such claims or

liabilities. The corporation, however, is not liable to indemnify the underwriters if the statement of a material fact which is claimed to have been untrue, or the omission of a material fact which is claimed to have been required to be stated or necessary to make the statements not misleading, was made in reliance upon written information furnished to the corporation by any of the underwriters.

Indemnity by the underwriters.—Similarly, each underwriter agrees to indemnify the corporation and each other underwriter against any and all claims or liabilities, and to reimburse them for legal expenses, arising out of or based upon untrue statements or omissions in the registration statement, prospectus, or newspaper prospectus, made in reliance upon information furnished to the corporation by the underwriter.

Thus, omissions or false statements as to the commissions to be received by subunderwriters or dealers, the persons or classes of persons, other than the general public, to whom the securities are to be sold, and the nature and extent of any substantial interest of the underwriters in any property of the corporation, are matters for which the underwriters customarily accept full responsibility.

Notice of action for indemnity.—Each underwriter is required to inform the corporation of the commencement of any action against it or against any person controlling it, and the corporation must inform the underwriters of any action brought against it in respect of which indemnity or reimbursement may be sought from such underwriters. The corporation is given the right to participate in the defense of any action brought against any underwriter, at its own expense, and the latter may join in the defense of any action brought against the corporation, at its own expense.

Hedge clauses.—"Hedge" clauses, also known as "force majeure," "out," "market," or "market out" clauses, are found in most agreements between the corporation and the investment bankers who underwrite or purchase an issue of securities.[20] This clause gives the underwriters, through their manager, the right to terminate the agreement any time before the date of public offering, or the delivery date, upon any substantial change in political, economic, financial, or market conditions. Termination may occur under the terms

[20] See paragraph 7 on page 399

of most agreements if there has been substantial loss to the corporation on account of fire, flood, accident, act of God, or other calamity which in the judgment of a majority in interest of the underwriters, or, in some cases, of the manager alone, renders it impracticable to consummate the sale of the securities at the price and in the manner provided in the agreement. Or termination may occur in the event that any major catastrophe such as the outbreak of war, national calamity, or act of God disrupts the financial markets of the United States. Such clauses for the protection of the investment bankers are found even in high-grade issues. While the principal reason for the hedging practice is the desire of the underwriters to minimize the risk caused by the waiting period required under the Securities Act of 1933 (see page 408), the uncertainty of the securities markets at the time of the revival of public financing in 1935 made bankers unwilling to make unconditional commitments. The clauses have rarely been invoked, but they continue to be included in most agreements.

Trading account.—The offering price must be maintained if the distribution of the securities is to be successful. To help stabilize the price, the underwriting or purchase agreement provides that the manager may, in its discretion, buy and sell securities of the particular issue in the open market or otherwise, for long or short account, on such terms and at such prices as the syndicate manager may think advisable.[30] It is also permitted to overallot the securities in arranging for sales to dealers. Purchases and sales for the trading account are made for the account of each of the underwriters as nearly as practicable in proportion to the respective principal amounts of securities which each of the underwriters has severally agreed to purchase or underwrite. A limit, however, of say 5 or 10 per cent of the principal amount of the securities is set for commitments under these provisions. Thus, if *X* & Co. has agreed to take $5,000,000 of a $50,000,000 bond issue as its participation in a purchase group, it may also be required to take an additional 5 per cent, if that is the agreed-upon percentage, or $250,000, of bonds which the purchase group manager has bought back in the stabilization process.

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[30] See clause 7 on page 402.

Market support operations have declined considerably since the enactment of the Securities Exchange Act of 1934. The principal reasons for the curtailment are: (1) investment bankers learned from their 1928–1932 experience that such operations may involve heavy losses; (2) investment houses want to avoid risking their capital, which is smaller in relation to the volume of business done than was the case before the depression, (3) the restrictions placed upon such stock market operations for stabilization purposes by the Securities Exchange Act of 1934 make market support difficult. While the Act does not prohibit stabilization activities as such, pegging, fixing, or stabilizing the price of a security is subject to regulation by the Securities and Exchange Commission.[31] Furthermore, the Commission requires the filing of daily reports by the manager, as well as by each of the underwriters, disclosing the details of the stabilization activities and the current status of the distribution. Members of national securities exchanges, dealers, and brokers who in any capacity effect a stabilizing transaction are expected to report also.

Trading account operations—repurchased securities.—The operation of the trading account may begin as soon as the offering is made. If the manager has overallotted the securities to dealers, he must buy back in the open market to cover any shortage, even if this means paying a premium for the securities. The premium would represent a loss in the trading account. Offsetting this loss, however, would be the fact that, at the termination of the syndicate, the market for the securities would be in a strong position.

Aside from making purchases to cover a short position, the manager will stand ready to buy any securities that come back to the market during the distribution process. Suppose, for example, that dealer *A* has sold a bond to *X* at the offering price, and *X* regrets his purchase. He throws the bond back on the market. Obviously, if many such securities come back, the price will fall and distribution of the securities at the offering price will be difficult. Therefore, the manager usually bids "penalty" for the securities in the open market

[31] See footnote 13, page 311, for a summary of provisions of the Act dealing with control of manipulation. The use of certain devices formerly employed to support the market, such as wash sales and matched orders, is now a criminal offense under the Act.

either directly or through brokers at the public offering price or below. When a bond has been acquired by the manager by this means, he notes the number and determines by whom the bond was originally distributed. The dealer loses his selling commission on that bond. If the examination of the number shows that an underwriter sold the bond, the manager, at its option, may require the underwriter to repurchase the bond at cost or may withhold from the underwriter the amount of the selling commission. In other words, there is a penalty against the original seller of the security.

In the case of stock, it is more difficult for the manager to identify the shares repurchased because of the ease with which shares can be transferred from one owner to another, and because there may be similar shares outstanding from the previous issue. Of course, if the manager has access to the transfer books, it can identify the stock, and in such cases treats the dealer or underwriter as indicated above.

Repurchased securities may be used by the manager to cover a "short" position in the trading account that has arisen through overallotment to dealers. The fact that the securities repurchased "penalty" have been used for this purpose does not save the original distributor from a cancellation of his commission on the sale. Distributors are not penalized, however, for repurchased securities acquired by the managers to cover a shortage created by overallotment, or for premium purchases made to create a better demand for the securities. These purchases are referred to as "no penalty-no prejudice" purchases.

Any profits or losses arising out of the trading account are credited to or charged against each individual underwriter's account in proportion to its participation. The managers may also, in their discretion, require each of the members to take up its pro rata share of any securities remaining unsold in the trading account at the termination of the syndicate.

Payment, carrying, calls, and loans.—As we have seen, the agreement between the corporation and the investment bankers requires that on the "closing" date the securities are to be delivered to the participants, and that the amounts agreed to be paid to the corporation are to be turned over to the manager for remittance to the corporation.[32] At the

[32] See paragraph 4 on page 398, and paragraph 1 on page 411.

close of the same day, if the deal has been successful, the manager reimburses the participants for any sums received from dealers on account of sales made to the selling group for the accounts of the participants. If all of the securities reserved for this purpose are not sold immediately to the selected dealers, two possible dispositions may be made of the securities during the life of the syndicate: (1) the manager may deliver to the participants at the offering price unsold securities in the syndicate account in amounts proportionate to the participants' obligations to take up these securities, the latter are usually subject to recall by the managers against sales made during the life of the syndicate. (2) The manager may retain the securities and borrow on them for the account of the underwriters. Interest paid on such loans becomes a part of the expense which each participant bears in the proportion that his share of unsold securities bears to the total amount of securities used as collateral for the loan. If there are coupons on the bonds or dividends on the stock, payable during the term of the loan, they are credited to the accounts of the participants in the same manner that interest is charged.

Selection of participants.—The factors determining the selection of participants in a true underwriting deal, that is, one in which there is an offer to existing stockholders, are the same as those influencing the selection of participants of the purchase group In current practice the originating house determines whom it will invite to be participants in the underwriting or purchase group. It also determines the size of the participation which will be offered to each participant. Since the liability of members of the group is several, that is, each underwriter is liable to the corporation only for the amount of securities it agrees to take, it is important to the corporation that only financially responsible banking firms be invited by the originating banker to be among the principal underwriters. Those selected houses which accept are known as the "principal" underwriters and appear as such in the registration statement and prospectus. In advertising matter, however, it frequently happens that only those who have a participation of a certain amount or more are mentioned.[33]

[33] The number of principal underwriters in large issues is too great for inclusion of all in the newspaper prospectus and other advertising It is inter-

The choice of participants and the amount which each will be offered are governed by such factors as the size of the issue, the relationship of the originating banker to the selected participant, previous association of participants with securities of the issuer, the ability of the participant to distribute the securities in certain localities, and similar factors.

Liability of participants.—In the following paragraphs we shall discuss only the liability of participants in a pure underwriting transaction and of participants in a purchase group, with regard to the unsold securities in the syndicate account. The civil liabilities of underwriters under the Securities Act of 1933 and other liabilities are not considered.

In a pure underwriting syndicate, formed in connection with securities that are offered to old shareholders (described on page 397), the underwriter agrees to take any of the unsubscribed stock in proportion to its participation. To illustrate: *A* & Co. agrees to take 5 per cent of any of the stock not subscribed for by stockholders. Assume that the unsubscribed stock equalled 1,000,000 shares. *A* & Co. would be required to take 50,000 shares, or 5 per cent of 1,000,000. If a selling group is formed to dispose of the unsubscribed stock, the liabilities of each of the participants for amounts not sold by the selling group would be the same as those of participants in a purchase group, as described below.

In a syndicate formed in connection with the purchase of an issue of securities from a corporation, the members of the purchase group must take back any securities not sold to the selling group, or to institutions for the underwriters' accounts, in accordance with the liability prescribed in the purchase group agreement. In most instances the agreement provides that each of the participants is liable for unsold securities in the proportion which the amount of securities "given up" for the selling group or for the group sale bears to the total amount of securities "given up" by the entire group for the same purposes. To illustrate: Assume that a total amount of $40,000,000 of bonds has been purchased

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esting to observe the importance attributed to the list of underwriters by some banking houses. Certain outstanding firms will not accept a participation unless their names appear either among the first few underwriters or at the bottom of the list. To avoid difficulty on this score, some head underwriters—that is, the originating banker in most instances—will list all the underwriters in alphabetical order.]

from a corporation by thirty participants, who have retained a total of $20,000,000 of the bonds. The balance of $20,000,000 has been offered to the selling group, which takes and pays for only $15,000,000. The purchase group is left with $5,000,000 of securities. Assume that *A* & Co. was one of the members of the purchase group who participated to the extent of 10 per cent of the issue, and retained $2,500,000 for itself and made $1,500,000 available to the selling group. *A* & Co. is responsible for $1,500,000/20,000,000, or 7½ per cent, of the unsold securities; that is, $375,000 of the bonds. In some agreements the liability of each participant for securities not sold by the selling group is based upon the proportion of the participation to the total amount of the deal Thus, in the example above, *A* & Co. would be required to take up 10 per cent of the returned bonds, or $500,000.[34] Sometimes the proportion of liability is the ratio of interest in the deal, but limited to the amount actually given up for wholesale.

The selling group members have no liability beyond paying for and taking up the securities which they have notified the selling group manager they have accepted.

Relation of participants to the syndicate or group.—The various agreements generally provide that the syndicate or group shall not be deemed a partnership, and that the members shall not be liable for the lapses of other members. If a member of a syndicate fails in his obligations, according to some forms of agreement, his place may be given to other subscribers or to new members. Moreover, he may be held for damages.

Compensation of participants.—The compensation of the bankers who have underwritten an issue which is being offered to old security holders is a commission of, let us say, 1 per cent of the amount taken by the old security holders, and progressively higher percentages of the amounts required to be taken up by the bankers; or, it may be a certain definite per cent or amount per share on the entire issue regardless of the amount to be taken up. Thus, the underwriters are paid a commission whether or not they are required to purchase any of the issue.

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[34] Prior to 1933, syndicate accounts carried one of two types of liability they were either (1) limited liability, also known as "divided account," or (2) unlimited liability, or undivided (joint) account. For an explanation of the liabilities under these two types of agreements, see footnote 18, page 406.

When bankers have purchased outright an issue of securities from a corporation, payment for the risk assumed is the spread or difference between the price at which the securities were purchased from the corporation and the price at which they are to be sold to the public. The bankers do not actually get this entire profit, since dealers' commissions, expenses, and compensation of the manager must be met, as illustrated in the following paragraph The spread may be great or small, depending upon the quality of the security. It will be small if the security is high-grade, that is, if it has a ready market because it is an obligation or equity of a well-known corporation that has an excellent earning record, it will be great if the security is second- or third-grade, that is, if the corporation is not well-known and its record not sufficiently well established to give the security ready marketability.[35]

Profits of participants.—Out of the gross spread between the purchase price paid by the participant and the public offering price, the participant must pay the selling group commission on that portion of his commitment "given up" to selected dealers, and his proportionate share of the compensation of the manager and of the expenses The latter include such costs as legal fees, advertising, investigation engineers' reports, and the like,[36] distribution expenses—such as telegrams, cost of delivering securities, and the like—losses on the trading account, taxes on sales made for the account of the participant, and sundry miscellaneous expenses.

To illustrate the calculation of the participant's profit, let us take a simple case. Assume that *A* & Co. participated up to $1,000,000 in a bond issue; it gave up $350,000 for the selling group and retained $650,000 for retail sale. Assume further that the gross spread is 2 per cent, the commission to the selling group is $\frac{3}{4}$ of 1 per cent, compensation to the manager amounts to $\frac{1}{4}$ of 1 per cent, and expenses are $\frac{1}{4}$ of 1 per cent. If the underwriter wants to estimate his probable profit on the deal, assuming that it will be a complete success, he makes a computation somewhat as follows:

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[35] See footnote 22 on pages 370 and 371

[36] Sometimes the corporation agrees to pay part of the costs, as, for example, the expenses of counsel for the underwriters, up to a certain sum

1,000 bonds at $1\frac{1}{4}\%$ ($2\% - \frac{3}{4}$)		\$12,500
Less:		
Pro rata expenses ($\frac{1}{4}$)	\$2,500	
Pro rata service compensation ($\frac{1}{4}$)	2,500	5,000
		\$ 7,500
Plus 650 bonds at $\frac{3}{4}\%$		4,875
Profit on deal		\$12,375

The same result could be obtained in the following way:

650 bonds at 2%	\$13,000	
350 bonds at $1\frac{1}{4}\%$	4,375	\$17,375
Less:		
Pro rata expenses ($\frac{1}{4}$)	\$ 2,500	
Pro rata service compensation ($\frac{1}{4}$)	2,500	5,000
Profit on deal		\$12,375

Losses of syndicates.—It must not be thought that syndicates always make profits. Indeed, during the period following the war boom in 1916, many syndicates undertook underwriting rather precipitately and found themselves facing large losses.[37] Similarly, the losses of syndicates at the change of the market in 1929, 1936, and 1937 were extremely heavy.

Powers of the manager.—Many of the powers of the manager have been mentioned in the preceding discussion. In general, it may be said that he is given absolute control of the situation; he is an oligarch, invested with all power and all authority. Without wishing to raise any collateral questions, we merely state that in practice, as far as American finance is concerned, the manager has usually been a benevolent despot. The explicitly stated powers of the manager may be briefly enumerated as follows:

1. To pass on the registration statement, prospectus, newspaper prospectus, and various forms of circulars sent to stockholders who are given the option to buy the stock (if stock is being sold) before it is taken by the syndicate.
2. To approve of the forms of certificates or of bonds.
3. To select the dealers for invitation into the selling group.
4. To agree to a modification or termination of the underwriting agreement.

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[37] See "Memorandum for the Interstate Commerce Commission on the Marketing of American Railroad Securities," prepared by Kuhn, Loeb and Company, for a list of outstanding syndicate losses in the railroad field. An excerpt from this report was included in the 1932 edition of this book at page 430.

5 To change the public offering price[38] and approve of amendments to the registration statement and prospectus.

In addition to the powers specifically enumerated, the manager has power to do anything he deems necessary in order to carry out the purposes of the syndicate or selling groups.

Obligations of the manager.—The manager is usually expressly exempted from all obligations accruing from any acts or omissions that do not amount to "gross negligence or bad faith." The agreement provides that apportionment and distribution by the managers of profits or losses, outlays, charges, and expenses shall be conclusive against the syndicate and the subscribers. Where fraud is evident, of course, resort can be had to the courts, even though the agreement may provide that the manager's statements are to be considered conclusive.

Work of the manager.—The work of the manager may be outlined in this somewhat chronological order: (1) investigating the proposition; (2) advising the corporation as to the best form of securities, and generally as to the financial plan to be pursued; (3) examining reports of engineers, accountants, and experts, and other material that forms the registration statement, prospectus, and newspaper prospectus, (4) drafting and executing the agreements made with the corporation, (5) selecting participants; (6) drawing up the various agreements and letters in connection with the formation of syndicates and groups; (7) marketing the securities; (8) supporting the market; (9) keeping the accounts, (10) making calls or negotiating loans; (11) distributing the unsold securities; (12) dividing the profits or apportioning the losses.

Compensation of the manager.—The manager obtains his profits from the following sources:

1. The agreement among underwriters almost always provides for compensation of the manager at a flat sum, or a certain sum per share upon all the shares of stock comprising the issue, or a certain per cent of the principal amount of the bonds comprising the issue This amount, which is charged pro rata against the accounts of the several underwriters, compensates the manager for acting as representative of the underwriters, handling the accounts, making arrange-

[38] Usually consent of a majority in interest of underwriters is required for a change of the public offering price.

ments with selected dealers, acting as manager of the selected dealers, and the like.

2. As a participant in the underwriting or purchase group, the manager is entitled to his share of the profits made by that group (See page 433.) Since the manager is usually the originating banker, his proportion of the underwriting is usually larger than that of the others, and his profit (or loss) is consequently larger.

Duration of syndicate and selling group.—The maximum duration of an underwriting syndicate or purchase group is generally stated in the agreements. Power is usually given to the managers to terminate the syndicate earlier than the specified time or to extend it for a certain period The usual duration is from thirty to sixty days with the possibility of extensions for a period or periods of thirty to sixty days. Several years ago, the duration was longer, a year being not uncommon.

The duration of the syndicate is fixed, in the first place, by the length of the time the managers believe it will take to distribute the securities to real investors; when the issue has been thus placed, the support of the syndicate may be withdrawn from the market without great fear that the securities will decline in price. If a portion of the securities remains unsold at the time the syndicate or purchase group is scheduled to terminate, the manager may, with the approval of the participants, extend the agreement [39] On the other hand, if the securities are all sold and assimilated before the date fixed for termination of the syndicate, and there is no longer any necessity for supporting the price of the securities, the managers may terminate the syndicate earlier than the scheduled date [40]

The duration of the selling group is limited in much the same way as that of the purchase group. Settlement of the underwriting accounts ordinarily takes place about thirty days after the termination of the selected dealers agreement, at the time of the termination of the agreement among underwriters.

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[39] If a large part of the issue is sold but the issue is "sticky," to use the language of the bankers, and too costly to stabilize, the agreement may be terminated at once A free market for the securities is thus created In such cases there are no price restrictions on anyone

[40] Many issues are never supported at all.

Advantages of syndicate underwriting to the corporation. For a number of reasons a corporation finds it advantageous to have its securities underwritten:

1. The corporation will get the benefit of the manager's advice on the kind of securities to be issued, the amount to be issued, the conditions under which the securities are to be sold, and the date at which the public offering should be made.

2 It is sure to get the full amount of money when and as required. Construction programs can be planned in full and in detail and carried through without loss of interest on amounts invested in early construction.

3 The corporation's credit is maintained. The mere fact that when securities are offered the announcement can be made that the sale is underwritten tends to establish the investing public's faith in the securities and in the company issuing them.

4 The managers usually keep watch over the company, and thus aid and guide it, in order to maintain their own reputations, which are involved in the success of the company after representations concerning it have been made in connection with the public offer of securities. If a company has established close relations with a banker, it may even expect to get temporary accommodations from that banker during bad times or during the process of preparing a security issue

5. Syndicate sale insures wide geographical distribution of the securities, and therefore saves them from future adverse local money market influences.

Advantages to the bankers.—The chief advantage which syndicate underwriting has for the participants lies in the profits. But syndicate operations also enable participants to obtain various kinds of securities to sell to their customers, giving the latter an opportunity to practice what the bankers advise—that is, to put their eggs in various baskets.

Advantages to the public.—The close co-operation of banking houses enables them to arrange public offerings of securities at different times. Thus, the market is not swamped at one time, but issues are "timed" to absorb the steady accumulation of investment funds by private investors and investment institutions The syndicate, in other words, has a steadying effect on the market—a desirable condition that would probably be wholly lacking if securities were thrown on the market haphazardly by the issuing corpora-

tions. By the responsibility placed upon underwriters for statements contained in the registration statement and prospectus, they are compelled to make careful investigation of the affairs of the corporations whose securities they underwrite or purchase Thus, the public is afforded some measure of protection against fraudulent and illegal offerings of securities.

Advantages to the buyers.—Those investors who buy underwritten securities are assured that their securities and the companies issuing them have been carefully investigated. They are assured, moreover, that money which is sufficient to see the borrower's project through has been provided, and that they will not be asked, as so often happens where investors put money into a company directly, to send "good money after bad money." Finally, the investor has the advantage of the underwriters' continued supervision of the company's financial affairs.

Competitive bidding for corporate security issues.—The suggestion was made to the Interstate Commerce Commission when it was investigating the terms and conditions to be prescribed by it in connection with the issuance of railroad securities under Section 20a of the Interstate Commerce Act, that railroads ought to substitute for the present system of forming permanent banking connections on which they can rely for underwriting of all issues, the system that prevails in connection with public securities, namely, advertising for sealed bids. The plan undoubtedly would include an announcement by the railroad of its intention to issue certain securities, and an invitation to the public at large or to the bankers to submit bids, the securities to be given to the *highest responsible bidder*. Railroad equipment trust certificates have been sold through competitive bidding since 1926. Issues such as municipal bonds and railroad equipment trust certificates are of such standard variety that they can readily be analyzed by many investment houses. Only issues that are standard are suitable for a system of competitive bidding. The present procedure followed by originating houses in carefully investigating all the details of a company's business before purchasing an issue of its securities would hardly be practicable under competitive bidding.

The trouble with competitive bidding, if applied to all securities, would be that the corporation could never be sure that it was going to receive any bids, or bids that it could

afford to accept. Moreover, the corporation would lose the constant oversight of the banker, his advice, and his support. Besides, the interests of the investing public would not be so well protected, for the corporation would be compelled to determine by itself the type, terms, and provisions of any contemplated securities, and would not be solicitous of protecting the interests of the investor with restrictive covenants and safeguards. If competitive bidding were required, successful banking groups might be forced to pay unwarrantedly high prices, only to find the securities unsalable except at a great loss.[41]

Regulation of underwriting in the public utility field.—In the public utility field prior to 1935, close tie-ups between the issuing corporation and the underwriter were common. Separate subsidiaries of public utility systems existed for the sole purpose of conducting the underwriting arrangements for the whole system. While the Securities and Exchange Commission, in administering the Public Utility Holding Company Act of 1935, has not ruled out interested underwriters in connection with the issue, sale, or acquisition of any security by a registered holding company or subsidiary, it has followed the practice of examining the underwriting arrangement very carefully to see that no unusual spread between the public offering price and the price to the underwriters exists because of the relationship of the underwriters to the issuer. Furthermore, in all cases except those in which underwriting occurs through public competitive bidding,[42] the Securities and Exchange Commission requires that it be notified of the underwriting spread and of any known conflicting interests of the underwriters at least seven days before the earliest date upon which the issuer desires a declaration to become effective.[43]

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[41] For a detailed analysis of the advantages and disadvantages of competitive bidding from the standpoint of public interest, see a letter to the editor of the *New York Times*, July 23, 1939, from Eustace Seligman

[42] In several of the States, including Massachusetts, New Hampshire, Maine, Vermont, and the District of Columbia, *certain* utilities must use competitive bidding in the raising of capital in excess of a certain amount rather than the more orthodox methods of negotiation between the utilities and their bankers.

[43] See Ernest R. Abrams, "Is Competitive Bidding for Utility Issues Ahead?" *Commercial and Financial Chronicle*, April 1, 1939, p 1862.

Chapter XXIII

WORKING CAPITAL

What is working capital?—The time-honored definition of working capital is the excess of current assets[1] over current liabilities. Two problems arise in connection with this definition. (1) what are current assets, and what are current liabilities, and (2) should the term "working capital" be applied to current assets, or in accordance with our definition, to current assets less current liabilities?

We define current assets to be those assets which in the ordinary course of business can be or will be turned into cash within a brief period (not exceeding a year, normally), without undergoing diminution in value and without disrupting the organization. If the reader will turn to page 127, he will find in the balance sheet there given a list of the assets usually accepted as current.

Current liabilities are those liabilities intended at their inception to be paid in the ordinary course of business within a reasonably short time (normally within a year), out of the income of the business. The classification given in the balance sheet on page 127 will again serve to indicate which liabilities are current.[2]

We must now meet the question: should the term "working capital" be defined as the current assets, or as the current assets diminished by the current liabilities? Those who argue for the former idea distinguish between "working capital" and "net working capital." They call the current assets the "working capital," and the excess of current assets over current liabilities the "net working capital."

The arguments in favor of this view have been set forth emphatically as follows:[3]

[1] No better example is afforded of the infelicities of accounting nomenclature than the hopelessly redundant words "current," "quick," "liquid"

[2] It will be noted that our classification excludes such debts as short term notes and maturing bonds, the credit obligation of which is generally met by a funding operation—issuance of stocks or bonds.

[3] J. O. McKinsey and S. P. Meech, "Controlling the Finances of a Business," pages 101–102.

The vice-president of a large bank in Chicago recently stated that working capital was the current assets of a business. Is there a tendency to adopt a new definition of working capital? If so, what are the arguments in favor of the definition given by the bank president? Let us go back to our balance sheet [see, for an example, page 127] and ask some questions about it. Is there any objection to saying that the fixed capital of a business is its fixed assets? Probably not. Do these fixed assets work for the owners of the business and produce profit for them? Evidently they do. May one borrow fixed assets by issuing bonds? Decidedly. Does a loan thus obtained increase liabilities? Yes. Turning to current assets, are the current assets earning profits for the owners of the business, just as do fixed assets? Do bank loans to business earn profits, just as do funds borrowed from bond investors, over and above the interest which must be paid to the bank? If not, why borrow from banks if only the proprietors' capital is profitable?

The two classes of assets are alike in so far as they are both partly borrowed, and both yield a profit over and above interest cost. Yet, whereas fixed capital is the fixed assets of a business, working capital is only the excess of current assets over current liabilities. To be consistent, why not call fixed capital the excess of fixed assets over fixed liabilities?

Let us carry our analysis a step farther. Let us suppose that part of our current assets are borrowed by issuing bonds. Has our working capital increased? Yes, if the usual definition be accepted. However, was not the money borrowed by an issue of bonds borrowed just as surely as though it came directly from the banks? The only difference is that the date of maturity is farther away in the case of the bond issue than in the case of a bank loan. Of still less significance is maturity when it is remembered that banks may carry businesses for long periods of time.

It would seem that the old definition of working capital was formed with the accounting definition of proprietorship in mind, and that the definition of fixed capital is an outgrowth of the economist's definition of the concept of "capital" as the "fixed instruments of production."

The arguments opposed to this view are as follows:

1. The definition of working capital as the excess of current assets over current liabilities is sanctioned by long usage.
2. Some of the statistical compilations now in ordinary use rely on this definition.[4]
3. There is no need of applying another term to a concept that already has so many other names; for example, "current assets," "liquid assets," "quick assets," "cash assets."
4. It is wise to have a term applicable to a certain group of mobile and variable assets left free after payment of current liabilities, which group is not increased when an equal sum is added to "current assets" and "current liabilities."

[4] See, for example, Moody's Manual of Investments; some others have varied their practice.

Thus, if we borrow $1,000, we increase "current assets" and "current liabilities" but do not increase "working capital."

5. It is wise to have a distinctive name for that excess of current assets above current liabilities which may be regarded as a safety fund to meet contingencies.[5]

In this chapter we shall dodge the issue by applying the term "circulating capital" to all the assets of a company that are changed in the ordinary course of business from one form to another, as for example, from cash to inventories, from inventories to receivables, and from receivables back into cash. The appropriateness of this term will be more apparent later when it is explained in connection with a diagram.[6]

The term working capital we shall then use as it has ordinarily been defined, as the excess of current assets over current liabilities. Since many of the problems raised in this chapter affect both circulating and working capital, we shall use the more familiar term, working capital, wherever either term would be appropriate, indicating, however, places where the distinction between these two terms becomes important. But it must be remembered that circulating capital always includes the working capital; it is the sum of the working capital and the current liabilities.

What are the problems of working and circulating capital? Before proceeding further, we may outline the problems that the business executive is likely to encounter in connection with the subject of working or circulating capital. They are:

1. What are the kinds of circulating capital, classified on the basis of purpose and source of derivation?

2. What is the proper amount of working capital for a concern? To solve this question, we shall have to discuss first the advantages of ample working capital, then say something about the dangers of too much working capital, and then enumerate and briefly discuss the elements that tend to influence the correct amount of working capital necessary for any given business.

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[5] The fact that we speak of "fixed assets" as the total fixed assets (not the fixed assets diminished by the fixed liabilities) is not a pertinent argument in favor of the "working capital" and "net working capital" idea, since we have in the fixed part of the balance sheet a complete nomenclature similar to that in the current part, thus current assets has its counterpart in fixed assets; working capital, the current assets less current liabilities, has its counterpart in "equity," fixed assets less mortgage indebtedness

[6] W H. Lough in his "Business Finance" uses the term "revolving capital."

Begin the study of this diagram with the cash fund Follow the main circumference Running to the left is cash used to pay employees, whose services applied to the inventories, at the top, produce the goods, which are sold and turned into receivables at right, which when collected come back as cash Taxes have a first claim on the property and income of the business and are therefore indicated in the form of a fund which may be gradually filled up during the year and then emptied on the tax days Just below the operating expenses is the asset, deferred charges (insurance, stationery, and other items), this represents expenses that were paid for in advance and that will not be used during the current year In the future, certain operations will draw from this asset rather than from cash

The next line to follow is cash going off to pay for professional and published services, such as lawyers' and accountants' fees, dues in trade organizations, magazines, tax services, sales services, and the like These are obtained in the first instance, it will be noticed, through the medium of credit, which credit is returned to the company when the debt thus created is "met" by cash These services are shown as promoting production, in fact, they promote sales and collections as well, but these avenues of promotion have been omitted for the sake of simplicity In the same way cash is shown, reading from left to right as the lines emerge from the cash fund, paying for merchandise, defraying sales expenses, redeeming credit given to advertising mediums, meeting the credit obligations arising out of the issue of bonds (note the sinking fund where cash may be accumulated in the form of securities, and so forth), and paying the collection expenses

In the very center is the vertical line indicating cash for administrative overhead and repairs, and carrying the profits into the surplus, part of which is to be turned out as cash dividends The funds that go into sales and advertising promote the sale of inventories and their conversion into receivables It will be seen that the credit department promotes the conversion of receivables into cash by its collection methods and that it prevents stagnation by cutting out sales to customers of doubtful credit standing Just below receivables will be found cash discounts granted to customers, these tend to accelerate the conversion of receivables into cash

The success of the business depends largely on how rapidly the circulating capital is kept moving For some reason—rapid increase in sales drawing off inventories, insufficient sales stagnating inventories, failure of debtors, or rapid increase in operating or administrative costs—cash may be drawn out more quickly than it is replenished through conversion of receivables In such an event, more cash must be injected into the circulating system If the business has expanded, perhaps a permanent increase should be furnished through the sale of additional stock or bonds to potential investors—this operation is shown below and to the right (Or the increase may be furnished through the sale of unnecessary fixed assets, an operation not shown on this chart See chart, page 375)

But temporary relief only may be needed In such an event, the concern may convert its marketable securities into cash (at right) or borrow from friends and employees (left) Or it may take from its customers notes (the dotted line running out of receivables) or accepted drafts, and discount them at its own bank or through a finance company or it may sell or assign its accounts receivable to commercial credit houses as security for a loan The bank may rediscount the accepted draft (trade acceptance) at its Federal Reserve Bank Customers may draw on their own banks and these bank acceptances may be sold to a discount house, which may sell directly to a Federal Reserve Bank Again, the company may take its own note to its own bank or may take a series of notes to a note broker who will sell them to outside banks Moreover, under certain conditions the company may draw on its own bank, the latter may accept the draft, and in that form, as a banker's acceptance, the draft may be sold to other banks These bankers' acceptances, under certain limitations, may be rediscounted with the Federal Reserve Bank, or the Federal Reserve Bank may buy the acceptances in the "open market" from the commercial paper houses The operations of the various credit institutions and banks are fully described in the text

The reader should at this point turn to the more elaborate diagram facing page 445 and study it with the aid of the explanation there given.

Kinds of circulating capital.—We may now classify circulating capital as fixed or variable.

Fixed circulating capital represents the amount of capital that normally will be found in the circulating system outlined. It includes the irreducible minimum necessary to keep up the circulation. In actual practice, we may say that it is the minimum amount of current assets found in the business during the year.

I. Fixed circulating capital may again be divided into:
   A. Initial circulating capital, and
   B. Regular circulating capital.
II. Variable circulating capital includes:
   A. Seasonal circulating capital, and
   B. Special or emergency circulating capital.

We may now explain further the peculiar nature of each of these four forms of circulating capital.

Initial circulating capital.—Ordinarily, a company meets its operating expenses out of its revenues. But at the outset, when the company's credit has not been established and when liberal terms of credit have to be given to customers, a cash fund may be necessary to maintain the outgo of cash while the income is in the less acceptable form of accounts receivable.

An imaginary example showing calculation of initial circulating capital.—We may assume a set of facts which experience shows would be likely to occur in an actual case, and we shall assume, moreover, that the business grows rapidly—this for the purpose of shortening the period over which we shall have to spread our study. A company plans to sell 500 machines a month at $150 a machine; for the first three months, however, it will sell only 100 machines, for the next three months, 200 machines, and thereafter 500 machines a month. Its investment in plant is to be paid for partly with the proceeds of bonds, to cover the interest on which, together with income and franchise taxes and insurance, the company will allow $10 for each machine sold. Administration and maintenance will take $20,000 per month, and manufacturing and selling, $70 per machine; collections and bad debts are estimated at

$1 per machine. Terms are "2/10, net 60,"[8] and one-half of the customers are expected to take advantage of the cash discount.

The financial results may be arranged as in the table on page 448. It will be noticed that collection expenses do not begin till the fourth month, when the collection of accounts is actually started for goods sold the first month, and that the allowance each month for this purpose is related to the sales made two months previously. Since the credit department collects the bills, the allowance made for collection does not cover salaries, which are accounted for in "administration," but it does cover special expenses, such as collection letters and attorneys' fees, and it includes also an allowance for bad debts. While interest ought not be charged per machine, but by the month (interest, of course, is a fixed charge), it was thought better to relate the item of fixed charges to the number of machines sold, in order to take care of the variations in taxes and insurance and of the increase in interest that would have to be paid on an increased investment in plant necessitated by the growing business. Moreover, such a procedure is in this instance justified since, after the first six months, the item does become fixed in the estimates.

The receipts are divided into cash payments and credit collections. The cash payments do not begin till the second month, since bills for goods sold the first month will usually be sent out at the end of the month and the cash discount, therefore, will be allowable to customers till the tenth of the second month. Collections from those who give credit do not begin till the fourth month, for it may be assumed that most debtors will take the full term of credit allowed after they have permitted the cash discount privilege to lapse. Some collections, to be sure, may come in during the third month, but it will be safer not to count on any cash income from this source before the fourth month.

The company, then, will need the sum of the monthly differences showing the excess of outgo over income for the first nine months, or $165,750. This sum is the company's initial circulating capital used to start circulation.

It may be asked: could not the initial circulating capital be borrowed from the bank—since after the ninth month the cash

[8] This expression means 2 per cent discount if paid within ten days; otherwise, the full price is to be paid in not later than sixty days.

TABLE No 8

ESTIMATE OF INITIAL CIRCULATING CAPITAL

Month	1st	2nd	3rd	4th	5th	6th	7th	8th	9th	10th
Number of machines sold per month	100	100	100	200	200	200	500	500	500	500
Cash Outgo										
Manufacturing and selling @ $70 per machine	$7,000	$7,000	$7,000	$14,000	$14,000	$14,000	$35,000	$35,000	$35,000	$35,000
Administration and maintenance	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000	20,000
Collection and bad debts, @ $1 per machine	...		. .	100	100	100	200	200	200	500
Interest, insurance, and taxes @ $10 per machine	1,000	1,000	1,000	2,000	2,000	2,000	5,000	5 000	5,000	5,000
Total	28,000	28,000	28,000	36,100	36,100	36,100	60,200	60,200	60,200	60,500
Cash Income:										
Cash payments—2 per cent discount		7,350	7,350	7,350	14,700	14,700	14,700	36,750	36,750	36,750
Collections from sales on credit	...			7,500	7,500	7,500	15,000	15,000	15,000	37,500
Total		7,350	7,350	14,850	22,200	22,200	29,700	51,750	51,750	74,250
Initial circulating capital needed	$ 28,000	$20,650	$20,650	$21,250	$13,900	$13,900	$30,500	$8,450	$8,450	None
Total initial circulating capital required	$165,750									

income is to exceed the cash outgo—and be paid off out of the excess of cash flowing in after the ninth month? Several factors prevent such a course. In the first place, the cash deficits, in practice, instead of running for only nine months, would likely run for several years. By the time net cash income became available, the corporation's stockholders would be clamoring for dividends. If a bank loan had to be paid off, dividends would have to be postponed a year or more. In the next place, all companies at the outset find use for money in their own business, for improving methods of operation, building up cash reserves for rainy days, and like needs. In this case, if the net cash income after the ninth month had to be used to pay off bank loans, the company might find itself in a very weak position, especially if a period of general business depression were encountered.

We may sum up the situation by referring to the diagram on page 445. Initial circulating capital is the amount of cash needed to start the circulation and keep it moving till the cash that returns by way of receivables collected is greater than the cash outgo in various directions. While a great part of this initial cash may, after the concern is well established, be replaced by credit, as it is thus replaced it will probably be absorbed in the business for other purposes. Hence, all the initial circulating capital (with the possible exception of a small part derived from merchandise creditors) should be derived from the sale of capital liabilities and not from the creation of current liabilities.

Regular circulating capital.—Every company needs such an excess of current assets over current liabilities as is necessary to keep up the circulation of the capital from cash to inventories to receivables and back again into cash. No business can afford to run the innumerable risks of enterprise without some margin of cash over immediate needs. Moreover, however closely "sold down" a business is, there will always be some circulating capital in the circulatory system. The regular circulating capital of a business is the irreducible minimum of circulating capital necessary to keep up the healthy circulation of current assets. It is therefore an amount of circulating capital which will always be found in the business. For example, in a retail store the inventories, or goods on the shelves, are a part of the current assets that make up circulating capital. Should we not, therefore, regard

these inventories as fixed capital, and should they not be derived from a fixed investment? A certain amount, expressed in dollars' worth of goods in stock, will always be found on the shelves; without that amount of goods in stock the business would lose its goodwill with customers. Hence such an irreducible amount of circulating capital is just as "fixed" as the capital tied up in the shelves on which the inventories rest It must be apparent, therefore, that this fixed capital should be raised as the other fixed capital is raised, through a permanent investment of the owners or through long term borrowing. As business expands, this "fixed" circulating capital will necessarily expand. If the cash returning from sales includes a large enough profit to take care of expanding operations and growing inventories, the necessary additional circulating capital may be provided by the surplus of the business. But whether the surplus should be used for this purpose is a question of dividend policy that we shall discuss later. Here, however, we must warn against the assumption that no part of the circulating capital is fixed, and that therefore all the circulating capital can be provided through short term borrowing.

Illustration of the danger of raising funds for regular circulating capital through temporary loans.—The importance of including regular working capital in fixed capital, to be acquired as such, is so well illustrated by one of the early experiences of John H. Patterson with the National Cash Register Company that we quote it at length from the life of Patterson by Samuel Crowther.

Mr. Patterson knew nothing of finance; he did not know how to borrow money, and, in fact, had never tried to borrow any outside of Dayton—and he already had the limit of the Dayton banks . . . . . .

He knew people in Boston, Mrs Patterson had lived in Brookline And to Boston he went for money—because he knew of no other place to go. He got in touch, through a note broker, with Joseph Banigan, of Providence, Rhode Island, a very wealthy man and the head of the largest rubber-manufacturing company in the country. He was also something of a money lender—that is, he would take a chance if the profits seemed worth while. He had been to Dayton and knew something of the N. C. R. business In December, 1895, Mr Patterson called on him and after some parley borrowed $10,000 for four months at 7 per cent, pledging for the first time a quantity of customers' notes. It was a poor bit of borrowing, the amount was only a fraction of what the company needed. There is every reason to believe that Mr. Banigan knew this, for he was an expert financier. There is a suspicion that Mr Banigan loaned the small sum because he knew Mr. Patterson would have to come back for more and that in the end

he might acquire an interest in the company—which he thought had a great future.

Mr Patterson thought only of the money that he needed for the moment. The loan was duly paid in April, 1896 By that time Building No 2 had been paid for at the expense of working capital and the company needed still another building The sales of 1896 were in excess of 16,000 and for 1897 promised to be still larger—they actually amounted to 23,057 Hardly had the note been paid than Mr Patterson was back with Mr. Banigan asking for a bigger loan—although not yet enough for his real needs. He borrowed $200,000 and the Board of Directors on May 6, 1896, authorized a contract between the company and Banigan The contract provided that the money should be advanced in instalments of $50,000 each through four months and that two years' interest at 7 per cent should be deducted in advance. The notes had to be indorsed by John H and Frank J Patterson and all the receivables of the company were pledged as collateral, with the further provision that these receivables should never be less in amount than $350,000—the company could withdraw receivables as they became due, provided others of like amounts were substituted. The company pledged to do all its borrowing through Banigan for a period and actually pledged $630,000 instead of $250,000 in customers' notes.

This was only the beginning of the borrowing. Up until the beginning of 1899 the company in all borrowed from Joseph Banigan and from John J. Banigan, who succeeded him, a total of $760,000, of which $375,000 was for renewals, making a net borrowing of $385,000 Only one of the original $50,000 notes was paid at maturity and the company had a hard struggle to do even that for the business kept expanding and requiring more money. The rate of interest on the renewals was 8 per cent, and the company paid $71,955 83 in interest to the Banigans during the period

[Mr. H. Theobald, Jr , an associate of Patterson, called the latter's attention to flaws in the contract with Banigan in a letter dated January 25, 1898 He listed the objections as follows]

1st—The necessity of showing in each January hereafter an equally good condition as now or no renewals will be granted.

2nd—Renewals will be granted in the future only upon the condition that we pay off $50,000 yearly, beginning in 1899

3rd—All the notes now in the vault and all that may accumulate in the future, no matter how large the amount may become, are pledged to Mr. Banigan as a collateral security.

4th—The contract is so worded that if by oversight or otherwise we should fail to pay the interest on any note on that day it is due, then all the notes outstanding at such time become due and payable and Mr. Banigan has the option to sell all the notes accumulated in the vault at such time. The contract should provide as a safeguard to us the above could be done only after our failure to make good such defaulted payment after receiving a notice from Mr. Banigan of such default

5th—The seriousness of indorsing all the notes in the vault making them payable to bearer, on account of the amount of these notes constantly increasing—and this process is to go on so long as we owe Mr. Banigan a dollar during the whole life of the contract.

The less we owe Mr. Banigan by paying off the yearly sum of $50,000 as stated in the contract, the greater the collateral security will become, so

that we may eventually hold here in the vault a million and a half of notes all pledged to Mr. Banigan for, say, a $100,000 debt, and still at such times as we would be unable to borrow any money for any purpose except through Mr Banigan at 8 per cent with all notes then on hand pledged as collateral security

6th—The option to Mr Banigan is so worded that if he desires we can never borrow any money, even for the purpose of paying him off, because we are bound by this contract to give him the first option of loaning to us all the money we can borrow in the future, and we agree in this contract not only to give him the first option, but that the conditions of such future loans shall be 8 per cent interest with J H Patterson's and F J Patterson's indorsement, and all notes pledged as collateral, so that, by this contract, we are tied to Mr Banigan (if he chooses) for all the time we owe him any sum of money at 8 per cent interest The only way left open to untie ourselves from him is to pay all of the indebtedness out of cash savings

[Mr. Crowther, in his admirable life of Patterson, shows how an experienced banker solved the working capital problem]

Mr. Patterson was ill and away from Dayton a good part of this time; probably worry over the notes was the chief cause of his trouble, for with the indorsements of his brother Frank and himself the notes bound up the entirety of the company and his own property—although his own property consisted almost wholly of the N. C. R. stock

He happened to be introduced to A C. Ratshesky, a young Boston banker, who had founded the United States Trust Company in Boston and who was an exceedingly keen man. Mr Patterson had never had skilled financial counsel; he went over his affairs with Mr Ratshesky and then Mr. Ratshesky made a trip to Dayton and did some investigating on his own account. He found that the company was extremely rich in assets and ought to have a fine future, but that it had no financial connections of moment and was woefully short of working capital Over all were hanging the Banigan notes. The first thing was to get rid of the notes and this was done by an issue of preferred stock, bearing 7 per cent interest, to the amount of $1,000,000 The Banigans agreed to float $600,000 of this stock at par, although on the side they received a commission of three dollars a share. . . . .

On April 9, 1900, the remaining $200,000 of preferred stock was sold.

The laws of Ohio did not permit an issue of preferred stock bearing more than 6 per cent, so the company took out a New Jersey charter. Eventually the incorporation was returned to Ohio and the capitalization, increased to $10,000,000, divided into $1,000,000 preferred and $9,000,000 common. Practically all of the common stock was held by John H Patterson and his brother Frank. On the death of Frank his stock went to his widow with the exception of a block that he bequeathed to Robert Patterson, his nephew.

With the Banigan notes out of the way and the prohibition against borrowing lifted, Mr. Ratshesky began to build up a credit for the N. C. R. He took promissory notes for his own bank and also he sold notes to other banks. Often he had the company borrow when it did not need the money, just in order to be able to make offers to buy back notes before their due dates. He also had Mr. Patterson always buy up his notes when money was

hard to borrow—not because it was good business, but for the moral effect on the banks It gives a notion of vast stability to have a concern out in the market trying to retire its notes when most other concerns are out trying to get money Working slowly and carefully, Mr Ratshesky built up for the N. C. R the bank credit to which it was entitled N C R notes became staples, and thereafter the company was never pinched for money

Seasonal circulating capital.—Beyond their initial and regular circulating capital, most businesses will require at stated intervals a larger amount of current assets to fill the demands of the seasonal busy periods. Thus, in the wholesale fur business extra funds will be necessary in the summer; in the dry goods business extra funds will be necessary to initiate the purchasing of goods for the four seasons of the year. It should be added that the very recent tendency is to abolish seasonal business as far as possible. The reasons for this tendency are obvious: capital is tied up for a shorter period if goods are bought as they are needed instead of for three or four months in advance; price changes in goods purchased can be more quickly reflected in selling prices if goods are bought to meet the needs of only a short period.[9]

Special circulating capital.—Most businesses need cash funds not only to get the business of buying and selling started, to keep good the credit for ordinary dealing, and to meet seasonal demands, but they also need at unstated periods extra funds to meet contingencies, such as the following:

1. Rising prices may affect the amount of current funds. When prices of commodities rise, it becomes profitable to increase inventories, since the resale price may include appreciation in value during the period in which the materials are being held for manufacture and sale.

2. Business depressions, too, may raise the amount of cash required. Though some businesses feel the halting hand of general depression more than others, all businesses require plenty of cash to ride out unusually stagnant periods.

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[9] Perhaps, however, this close buying is merely a concomitant of a period of generally falling prices. In recent years a reduction in the amount of working capital needed has been noted for business in general The reasons for the reduction are: (1) hand to mouth buying, (2) greater efficiency in handling inventories of merchandise, (3) increased efficiency of the railroads in bringing goods to and from their markets, (4) reductions in sums required to finance customers, brought about by greater use of trade acceptances, sight drafts, and more persistent collections, (5) increased effectiveness of cash balances as a result of closer coördination of banks through the Federal Reserve System, more rapid clearance of checks, telegraphic transfer of funds, and the use of air mail.

3. Contingencies, such as strikes, fires, and unexpectedly severe competition, may use up extra supplies of cash.

4. Special operations, such as the inauguration of extensive marketing campaigns, experiments with products or with methods of distribution, carrying out of special jobs, such as war contracts, contracts to supply new businesses, and similar operations that are outside the usual business of buying, fabricating, and selling, may require additional funds.[10]

Advantages of ample working capital.—From whatever source the demand for current funds arises, that business may count itself fortunate that has an ample supply to meet all needs.[11] The advantages of such a position may be enumerated as follows:

1. The most important advantage is the least tangible—the maintenance of a satisfactory morale in the business. "Nothing succeeds like success," and nothing gives the appearance of success as readily as the ability to meet promptly and without effort all reasonable demands for cash payments. However, it is not the effect on others so much as the effect on the managers themselves, that is important; the feeling of security, the sense of power—these promote that self-confidence which psychologists so frequently tell us is an element of success.[12] Worry on the part of managers over

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[10] The diligent reader will readily discover the effect of each of the contingencies named on the circulatory system shown in the diagram on page 411

[11] During the period of prosperity which lasted from 1925 to 1929, many large corporations took advantage of the strong market for investment securities and raised working capital by the sale of common stock With part of the proceeds they paid off a portion of their floating debt, thus improving their current positions As a result of this financing, when the depression of 1929 arrived they were in a position to cope with the tightened credit conditions and were not entirely dependent upon commercial banks to aid them through difficulties. See, however, an article by Badger and Behrens, "Financing by Stock Rights," in *Investment Banking*, April, 1931, page 37, in which, from a study of the financial statements of twenty-four large industrial corporations, the conclusion is reached that except for a few isolated cases there is no evidence that corporations entered either the year 1929 or 1930 with more than a normal amount of working capital A later study by Arthur H Winakor, entitled "Maintenance of Working Capital of Industrial Corporations by Conversion of Fixed Assets," (1934) Bulletin No 49, University of Illinois, based upon financial statements of 182 companies operating in 16 different industries from 1927 to 1932, inclusive, indicates that at the beginning of the depression most corporations were well endowed with working capital and special reserve funds of marketable securities.

[12] See, for example, William James, "Psychology," Vol II, page 310. A simple mathematical manipulation of the algebraic formula there given will yield the statement given in the text.

"how the pay roll is to be met" is likely to impair efficiency when broad policies are to be worked out and important details are to be regulated; financial weakness breeds contempt among employees.

2. Credit is maintained. Credit is the power to obtain present goods and services on the promise to pay in the future. From a very practical standpoint, one's credit rating is based on one's capacity to pay and on the promptness with which payments are actually made.[13]

3. Cash discounts may be taken. Perhaps the usual terms on which goods are bought in business are what the credit man calls "2/10, net 30." These words mean that if goods purchased are paid for in cash within ten days from the date of delivery, the purchaser may subtract 2 per cent from the amount of the invoice; this deduction is called the cash discount. The goods are supposed, at any rate, to be paid for within thirty days after delivery, though, as we have shown in the problem involving the sixty days' credit period, in practice the debt is usually not paid till thirty days after the first of the month succeeding the month in which the goods are bought. Thus a purchaser gets 2 per cent discount for paying twenty days earlier than the date on which he can be compelled to pay.[14] The discount, therefore, is practically at the rate of 2 per cent for twenty days, or 36 per cent per year. Some houses quote terms of "2/10, net 30," but if their customers cannot pay cash and thereby earn 36 per cent on the investment, the credit terms are withdrawn and cash is insisted upon. "To him that hath shall be given."

4. In order to borrow cash from the banks—we shall see that borrowing from the banks is a wise course, especially to

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[13] Dun & Bradstreet, Inc., the principal commercial agency, gives a double rating, one for estimated pecuniary strength, and one for general credit. Thus AA-A1 means that the pecuniary strength is $1,000,000 or over (AA), and the general credit is the best (A1).

The appointment of a receiver for the Virginia-Carolina Chemical Co. in March, 1924, was due to the fact that the company had relied too heavily on bank loans. When some of the banks refused to renew their loans, others became nervous and a receivership was precipitated. The company had not distinguished between regular circulating capital, which ought to be financed like any other fixed capital, and specified or seasonal capital, which ought to be obtained only through bank loans.

[14] He may wait till the tenth day to take his cash discount; twenty days thereafter, his thirty days' period of credit will be up and if he does not then pay, he may be successfully sued.

obtain seasonal circulating capital—a business must keep itself in fairly liquid condition.

The old theory was that working capital should equal current liabilities, that is to say, that there should be $2 of current assets for every $1 of current liabilities. This is the familiar "2 to 1" rule. It was based on the belief that an allowance of 100 per cent should be made for shrinkage in circulating capital in the event of a forced liquidation. The ratio has been criticized as a dangerous tool when carelessly used, because it fails to give weight to the variations in liquidity between the component parts of the ratio. The liquid position of the company is better determined by an analysis of the liquidity of each of the items that make up the current ratio. The two to one ratio may be found satisfactory in some industries and entirely too low in others; it may be found sufficient at one phase of the business cycle and insufficient at another. Ratios in addition to the current ratio are at present in use to determine the current position of a company.[15]

5. Efficiency is maintained. Ample working capital prevents the decline in efficiency that sets in when operations are impeded by lack of materials, delays in obtaining necessary supplies, and other accompaniments of a shortage of working capital.

6. The corporation can tide itself over a period of depression if its working capital is adequate. The pressure upon working capital in such periods and the difficulty of turning fixed assets into more liquid form and raising cash make it advisable to carry a reasonable surplus of cash even though the carrying may mean that the company will earn no income on its cash balances.[16]

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[15] See "The Use of Financial Ratios," *Harvard Business Review*, October, 1925 Also Wall & Duning, "Ratio Analysis of Financial Statements," and James B Trant, "Bank Administration" See also page 485 of this text

[16] The Federal banking laws prohibit the payment of interest on demand deposits by any bank that is a member of the Federal Reserve System or by any nonmember bank whose deposits are insured by the Federal Deposit Insurance Corporation. Interest may be paid on time and savings deposits in member banks and insured nonmember banks, as limited by regulation Restrictions are also placed upon payment of time deposits before maturity

Prior to the enactment of the Banking Act of 1933, payment of interest on checking account deposits was permissible The methods of paying interest varied from city to city and from bank to bank, just as today the practice of requiring a minimum balance and of making a charge for service when the balance falls below the minimum varies throughout the country and from bank to bank.

Disadvantages of redundant working capital.—Although cases of this kind are rare, conditions do sometimes arise in which a business finds itself, for a period, with much larger supplies of cash than are needed. Such a condition contains the following elements of danger:

1 Waste may be encouraged, especially through the purchase of unnecessary equipment and the installation of experimental plans without regard to their practicability The danger is not only in the dissipation of the cash but in the loss of morale.

2. Manipulation may be invited. If unusually large supplies of cash are on hand, the directors are likely to invest business funds in private enterprises

3. Interest is lost. Some concerns invest surplus funds in good marketable securities and then use them as collateral for bank loans when the cash is needed [17]

4. The corporation is likely to lose sight of the importance of maintaining such relations with its banks as will assure credit when the need for it arises

5. Since large balances of cash may profitably be invested in producing assets, a plethora of cash assets may be taken as an indication that the managers are not expanding their business. In conclusion, it ought to be said that if the directors cannot find a profitable use for surplus funds, they ought to pay them out to the stockholders and permit the latter to invest the money.

What is the proper amount of working capital?—The answer to this question must be the same as that given to the question, how large should the whole company be, which answer we gave in the words of Lincoln in his famous reply to the inquiry, "How long should a man's leg be?"—"Long enough to reach the ground." And here we must say that in every case the circumstances surrounding the individual company must be taken into consideration. Certain general principles, however, may be briefly explained:

1. Businesses with regular gross income in the form of cash prepayments for goods or services need relatively little working capital. If the traction company with its signs, "Pay as you enter," cannot meet demands for cash, the trouble is not with the working capital, but with the whole business. Ordinarily, about one to two months' operating expenses are con-

[17] See, for example, items 9 and 10 in the balance sheet, page 127.

sidered adequate for public utilities.[18] Since operating expenses are about 70 per cent of gross revenues, another way of stating the average amount of working capital necessary for a public utility is to call it "an amount equivalent to the revenues for from 7/10 to 14/10 months.[19]

2. As the volume of business expands, the demand for working capital increases—not only because a relatively larger working capital is necessary to keep up credit, but also because actual cash outlay is likely to exceed the cash income, the excess being represented by fewer liquid accounts receivable.[20]

3. Cost of manufacture will have something to do with the amount of working capital required, not only because high costs mean that large sums of cash will be tied up during the period of manufacture, but also because all expenses are likely to be in scale with direct manufacturing costs. Errors, for example, in the manufacture of hand fabricated, complex machinery make a greater drain on cash than errors in the manufacture of more simple products.

4. Time consumed in manufacture will also have some effect on the cash requirements. Obviously, the longer the period of manufacture, the larger the amount of cash required. However, if the flow of products is quite steady, while the cash value of goods in process is large, the working capital will not vary much from time to time. In other words, while a given large amount of regular circulating capital will be needed, a comparatively small amount of this need be in the form of cash. A large part of the goods in process, therefore, may be regarded as strictly a fixed asset.

5. Turnover, or the number of times a given amount of circulating capital can be turned over during the year, will also

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[18] See Lagerquist, "Public Utility Finance," for a list of methods that have been used by utility commissions in arriving at an allowance for working capital in various types of public utilities.

[19] It will be noted that in the first sentence of the above paragraph we referred to companies (a) having a regular income and (b) doing a "cash with sale" business. To the extent that either of these elements is lacking, the supply of cash capital should be increased. Public utilities are the best example of businesses in which both elements are strongly present A retail store, on the other hand, may do a "cash" business, but its income may be very irregular.

[20] See on page 448 the illustration of initial circulating capital and notice how the cash outgo increased in the fourth and seventh months, when the sales increased.

be an important factor in determining working capital requirements. The expression "turnover" has given writers on the subject as much trouble as the term "working capital." These questions arise: (1) Do we mean turnover of circulating capital, of working capital, or only of merchandise? (2) In calculating turnover, should we divide the items circulating capital, working capital, or merchandise, into gross sales or into sales at cost?

In answering the first question, we may say that the chief consideration should be to use the same item, whichever is chosen, when comparing the turnover of two concerns or when comparing in one concern the turnover of one year with that of previous years.

As between working capital and circulating capital, it would seem that the latter is the more significant. The purpose of studying turnover is to see how fast the circulating capital circulates; there is not much to be gained by distinguishing between the total circulating capital and the net owned circulating capital, that is, working capital.

As between circulating capital and merchandise, the choice will depend on the nature of the business. In a large manufacturing house which extends credit to its customers, the significant turnover is the turnover of all items of circulating capital, and not the turnover of merchandise alone. In a mercantile business, as for example, a retail store which sells for cash, the fact that is most significant is the number of times the goods on the shelves are sold.

In answering the second question, this observation should be made: turnover of circulating capital is best determined by dividing circulating capital into gross sales, turnover of merchandise should be calculated by dividing average inventory into sales at cost. This practice should be followed because merchandise is usually written in the books and carried at cost. To find out how many times a dollar invested in merchandise is turned over, we cannot include in the dollars of sales of that merchandise the profit involved in the sale. Thus, if a store has $20,000 of sales and a stock of merchandise of $5,000, we may assume that of the $20,000 about $4,000 is profit, leaving "sales at cost" $16,000, and giving us a turnover of merchandise of 3.2. Another way to figure the turnover, where only the total annual sales and the merchandise are known, is to assume a certain "mark up," that is, a rate of

profit added by a mercantile establishment to the purchase price in order to arrive at the selling price. Thus, in the above case we assumed a "mark up" of 25 per cent; our divisor would become $5,000 plus 25 per cent of $5,000, or $6,250, which divided into sales (gross, not at cost, since we have added the profit to the merchandise and therefore may leave it in the sales) yields the same turnover of 3.2.

It should be added that whatever kind of turnover is being utilized, whether that of circulating capital or that of merchandise, the average amount of the capital or merchandise should be used. In other words, the divisor in each case would be one-half the sum of the circulating capital (or merchandise) at the beginning and at the end of the year, and not the same item taken at one time of the year only. In the case of merchandise, average monthly inventories, if maintained, should be used.

Some examples of turnover.—An example of turnover of circulating capital may be provided by using the balance sheet on page 127, together with figures taken from reports of the company whose condition this statement represents. At the end of the year, the circulating capital was $114,-340,264. At the beginning of the period, circulating capital, as shown in the previous annual report of the company, was $111,396,065, making the average for the year $112,868,165. Sales for the year were given in the annual report as $131,866,-111. Thus the turnover was about 1.17.

An example of turnover of merchandise is furnished in the following excerpt from a report on an examination of retail statements made in an investigation conducted by A. D. Sallee of the University of Pittsburgh and the Pittsburgh Chapter of the National Institute of Credit.[21]

Figures submitted by 627 grocers show total annual sales of $13,953,126, an average of $22,254 each, and total merchandise on hand $2,253,214, an average stock of $3,594. This shows average sales of $72.25 for each business day. If a thirty per cent mark-up is allowed the figures show the stock turns once in sixty-four business days (about seventy-four calendar days) or 4.91 times per calendar year. A smaller mark-up would increase the stock-turn.

The 196 general merchants reporting both sales and merchandise, show total annual sales of $7,396,881, an average of $37,739 each, and total merchandise on hand $2,038,260, an average of $10,399. This shows average

[21] A department of the National Association of Credit Men.

sales of $122 52 for each business day. On a thirty per cent mark-up this would make the stock turn over in 110 business days (about 171 calendar days) or 2 13 times per calendar year.

Here again, however, we must warn against the commonly held notion that quick turnovers reduce the *cash* requirements. The mistake consists in not realizing that where turnover is slow, a reasonable amount of materials on hand can be treated as fixed assets. Assume a hardware store with a turnover of one a year and a grocery store with a turnover of six a year and assume that each has the same average amount of stock on hand, namely, $25,000, and that each sells for cash. The grocery store, having to replenish its stock more frequently, will need more cash than the hardware store. Both stores will at the outset use up a definite amount of cash in stocking up, but thereafter the hardware store will need less cash than the grocery store to keep a full line on hand. To be sure, if we compare two grocery stores with the same annual sales, and if we assume that one can sell its stock more quickly than the other, the former will have less cash tied up permanently than the latter, because of the more frequent turnover. It is wise, however, to stress the fact that we are discussing here merely the amount of cash funds required in relation to turnover.

The impression should not be left that quick turnover is not distinctly advantageous to a business. In the above illustration, for example, we may assume that the hardware store and the grocery store will have to maintain the same floor space to carry the $25,000 stock that is always on hand; hence the rent will be the same. This is also true of insurance. And the same is true of the interest on the $25,000 which on the average is tied up in merchandise in each case. But the grocery store with its turnover of six can spread these fixed costs over six times as many articles as the hardware store, which we have assumed has a turnover once a year. Moreover, a concern with a quick turnover does not run so great a risk of losing money through obsolescence, damage to stock, and declines in prices. Other things being equal, profits will be larger where the turnover is more rapid, though the actual circulating capital required to keep the shelves stocked may be the same in the latter case as in the former.

In comparing the efficiency of businesses, one with another, the ordinary turnover ratio of merchandise to sales is impor-

tant. The hardware store, for example, which has a turnover of merchandise of one and a quarter a year is better than the other one which has a turnover of one a year. The latter company will make less profits per unit of goods and per dollar invested in the business. It will likely have stale goods on its shelves, goods that may lose value in the ways indicated above.

It must appear, therefore, that the ordinary merchandise turnover is a factor that should be closely watched. The executive should compare his current turnover with those in previous years and with those in similar businesses.[22]

6. Terms of purchase, if favorable, will reduce working capital requirements. It is important, here, to distinguish between circulating capital, or gross current assets, and working capital, or net current assets. Buying current inventories on credit will not reduce the amount of circulating capital needed, though it will reduce the amount of working capital or *owned* circulating capital needed. Indeed, since, in most cases, merchandise can be bought at a discount if paid for in cash, the amount of circulating capital needed to do a given amount of business will be greater where credit is used instead of cash.[23]

7. Terms of sale, where cash prepayment or cash is not stipulated, have a great effect on the cash requirements. Notice again that terms of sale in selling, like terms of sale in

[22] See J. H Bliss, "Financial and Operating Ratios"

[23] The credit used in the purchase of inventories is usually dearly paid for. Where terms are "2/10, net 30" (2 per cent if paid in ten days, otherwise net and to be paid in thirty days), the rate of interest amounts to 36 per cent If, for example, $100 is borrowed at the end of the ten day period—just in time to get the 2 per cent discount—and then is repaid twenty days later when the bill is supposed to be paid at any rate, the purchaser will have received 2 per cent for the use of the money borrowed for twenty days, or one-eighteenth of a year Thus, the gross cost of the thirty days' credit will be at the rate of 36 per cent per year Cost of credit for other terms of sale is indicated in the following table:

One-half per cent in ten days—net 30 days—equals 9 per cent a year.
One per cent in ten days—net 30 days—equals 18 per cent a year.
One and one-half per cent in ten days—net 30 days—equals 27 per cent a year.
Two per cent in thirty days—net 4 months—equals 8 per cent a year.
Two per cent in ten days—net 60 days—equals 14 per cent a year.
Two per cent in thirty days—net 60 days—equals 24 per cent a year.
Two per cent in ten days—net 30 days—equals 36 per cent a year.
Three per cent in ten days—net 4 months—equals 10 per cent a year
Three per cent in thirty days—net 60 days—equals 36 per cent a year.
Three per cent in ten days—net 30 days—equals 54 per cent a year.

purchasing, affect the cash requirements, not the circulating capital requirements If customers are given "easy terms," circulating capital will tend to pile up in receivables and some form of financing these receivables will be necessary.[24]

At this point the problem of financing often becomes a problem in sales management. If, for example, goods are sold to be delivered several months later and a customer is then to have thirty days' credit, the selling house may have to pay a commission immediately to its representative who made the sale, though no cash will be derived from the sale for three months. In such a case the customer may be induced to pay some cash in advance—a suitable discount being offered—and the salesman may be led to make the sale on the cash advance basis by being offered a differential commission, that is, for example, a commission of 18 per cent for a credit sale and a 20 per cent commission if the sale is made on a cash-with-order basis. Moreover, a part of the commission may be "n.c.u.p."—"no commission until paid."

Where sales are made on the installment plan, receivables are likely to pile up in the same way. Here again a differential price may be offered—lower for cash or for large installments than for the easiest terms allowed—and the salesman may be paid a differential commission, "n.c.u p.," that is, he may be paid a larger commission for cash sales, and for installment sales he may receive a smaller commission, broken into installments each of which is to be paid as the customer pays an installment of the price. While the lower price and the higher commission for the cash payments may seem to make large inroads on the margin of profit, the correct way to view the situation is to assume that all sales are to be made on the cash basis and the margin of profit is to be figured thereon. The price for credit sales then will be raised sufficiently to carry the load of special financing of the accounts receivable and of collections. In other words, the cash discount allowed customers and the larger commissions paid salesmen will offset the cost of collecting, as well as the losses from bad debts, and the cost of financing the receivables.

8. The hazards of the business affect the amount of cash required. A concern selling a low priced article through the mail, for example, will need much more cash than one that

[24] See the work of commercial credit houses, Chapter XXV.

TABLE No 9
EFFECT OF BUSINESS ACTIVITY ON INVENTORIES[25]
(000's omitted)

	1937	*1933*	*1929*	*1924*	*1922*	*1918*	*1914*
Allis-Chalmers	$36,723	$10,218	$16,141	$12,103	$10,009	$17,436	$4,149
Amer. Agricultural Chemical	6,313	3,482	7,800	9,628	13,318	19,523	9,104
American Locomotive	10,408	4,731	9,800	7,705	15,337	21,432	3,962
Armour & Co	56,649	40,788	127,976	111,469	79,458	150,380	44,672
Bethlehem Steel	104,109	51,673	69,147	79,850	50,938	79,596	11,130
Corn Products	8,543	7,514	8,283	10,447	8,389	11,226	3,926
Cudahy Packing	29,570	16,204	21,823	19,739	18,504	43,266	14,079
Diamond Match Co...	7,788	5,776	6,258	7,648	8 954	10,382	5,189
General Electric.	113,046	48,995	80,835	68,485	75,334	88,305	29,292
Goodrich, B F	43,371	25,582	46,284	19,921	22,811	34,965	11,308
International Harvester ..	155,915	85,690	102,295	88,638	87,810	114,516	35,402
Montgomery Ward	77,361*	48,360*	67,145	26,322	18,718	27,101	6,780
National Lead Co	22,085	16,224	18,314	18,483	19,549	15,027	7,164
Packard Motor Car	12,987	5,450	13,237	11,121	13,707	22,399	6,394
Swift & Co	109,295	72,981	127,561	105,124	86,424	179,060	45,899
U S Industrial Alcohol	7,663	5,011	6,659	3,655	4,061	7,072	1,000
U S. Steel.	331,479	252,331	288,572	285,041	220,707	274,753	158,091
Wilson & Co	28,482	16,232	27,391	28,089	18,167	43,762	8,692
Woolworth, F W	46,494	35,424	39,816	25,378	20,920	18,431	10,491

[25] This table should be compared with the chart of business activity on page 329 The relation of inventories to business activity is shown further by an analysis of the reports of 494 corporations made in 1928 by Ernst and Ernst, accountants, and reported in the *Annalist* of April 12, 1929 The study showed inventories at the end of 1928, which was a more active year than 1927, to be 6 80 per cent higher than at the close of 1927 Sales for these companies were 8 16 per cent higher in 1928 than in 1927. The commodity price level, according to the Bureau of Labor Statistics, in 1927 stood at 95 4 and for the year 1928, at 97 7.

* As of Jan 31, 1934 and Jan 31, 1938.

sells to customers coming to a store and paying cash, not only because money in the former case is tied up in accounts receivable, but because a change in business conditions may render a number of the debtors insolvent.

9. Finally, the business cycle will change the need for working capital. In times of rising prices, inventories must increase in order that goods may be bought while costs are relatively low. Increasing prices, too, nearly always indicate shortage of supply and a careful business will want to stock up in order to maintain its production capacity.[26] The table on page 460 shows how inventories increased in many industrials during the years 1914 to 1918, fell off in 1922 with the sharp decline in prices, increased with the expansion of business between 1924 and 1929, declined again to a low point in 1933 with the depression that began in 1929, and rose with the post-depression recovery.

As was pointed out above, the cycle will cause need for increases in working capital during periods of expansion and also during periods of severe depression. During the latter periods cash will be exhausted, for fixed operating expenses —such as rent, administration, and the like—must be paid even though sales do not provide income to meet them.

Conservation of circulating capital.—We must now spend some little time on the subject of the conservation of circulating capital. What is said in the following paragraphs will be better appreciated by the reader who keeps in mind the diagram of circulating capital given on page 445. Many of the subjects that might properly be taken up now are considered somewhat at length in a later chapter on management of income. Here, however, we must briefly call attention

[26] The author is well aware that just such reasoning as that given above has been responsible for bad social conditions If, as prices rise, every manufacturer and dealer "runs to cover" and seeks to stock up, he thereby stimulates demand and contributes to an unnecessary boosting of prices During the war years and the years following, this practice was accompanied by one more vicious—the practice of duplicate orders. To be sure that the goods necessary for production and resale would be available, business men gave complete orders to several houses and then canceled all orders after the first delivery had been made, unless, of course, prices continued to soar, in which event the goods from several houses were welcomed at the original prices The result was that the houses of supply made great demands on the manufacturers—till the first signs of slackening business appeared, whereupon cancellations came in, houses of supply found themselves greatly overstocked, and prices tumbled The true summary will be found in the decline of 48 94 per cent in the general level of prices in the months from March, 1920, when Bradstreet's index of commodity prices stood at 20.7950, to June, 1921, when the index fell to 10.6169.

to the places in the circulating system where, if attention is not given, leaks will occur, or where the circulation will become stagnant.

Conservation of circulating capital through proper production methods.—If we reexamine the diagram of the circulating system of a business, we find that cash, after taxes have been attended to, is first directed to operations. Where much can be saved by paying expenses well in advance—in which event the expenses paid are treated amongst the assets as deferred charges—the expenses should be so paid. In the production department itself, any leak will tend to draw circulating capital. This statement is especially true of competitive businesses; in a non-competitive business the cost of the services applied to the inventories in turning them from raw materials into finished products can always be passed on to the customers, but in competitive businesses the price of the product is fixed by competition and the profit of the company is measured by the cost of production.

To keep down cost, products and methods should be standardized; labor should be controlled in the most efficient ways known to the business world; wage scales must be scientifically arranged; proper incentives must be given to all employees, and the aim should be to expand the business to that size where the advantages of large-scale production begin to lose their value because of the burden of the overhead costs of co-ordinating a large business.

Conservation of circulating capital through scientific purchasing.—The diagram of the circulating system shows that circulating capital goes through merchandise creditors into the inventories of a company. The task of seeing that these are properly acquired belongs to the purchasing department. But the latter must depend largely on the financial department, for if the credit extended to a company to permit it to procure merchandise is not promptly liquidated, the purchasing department will find that its purchases cannot be made on favorable terms. The purchasing department should bring constant pressure to bear on the financial department to persuade the latter to take cash discounts wherever they are allowed.

Moreover, the purchasing department must bring pressure to bear on the sales and production departments to persuade them to standardize the output. If the sales department is

allowed to make special arrangements with almost every customer, orders may be accepted that call for unstandardized products and these will call for unstandardized purchases The production department, too, should be urged to standardize its products.

The purchasing department should constantly study the business cycle so as to be enabled, first, to buy materials at the trough of prices, second, to have a reasonable stock of material on hand as business becomes more active, and third, to have the shelves bare when prices begin to tumble and business to stagnate.

Finally, the purchasing department must not permit leaks as a result of the purchase of goods without reference to the purpose for which they are to be used. Where, for example, coal can be bought by the calorific content rather than by the dead weight, the company will likely buy what it needs, heat, at a relatively low figure.

Relation of sales to circulating capital.—By referring to the diagram, we can realize that circulating capital may be conserved if it is not permitted to be piled up in inventories. The first duty of the sales department is to keep up a vigorous transformation of inventories into receivables. But as the circulating capital moves from inventories into receivables, it is increased by the factor of profits. The sales department, as a result, is faced with its most difficult problem—the fixing of a proper price policy. On the one hand, low prices will tend to accelerate the circulation; on the other hand, high prices will swell the stream as it moves. The subject is properly studied as a problem in marketing, though it is again discussed in the chapter on management of income.[27]

Moreover, the sales department must see that no leaks of circulating capital occur. The chief consideration should be to see that errors are not repeated. The advertising department especially, should keep very accurate and detailed records of its attempts to push sales and should constantly resort to its records of past experiences in laying its new plans.

Credit department's part in conserving circulating capital.—The part of the credit department in conserving circulating capital is clearly shown in the diagram. In the first place, the credit department must see that bad accounts do not get

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[27] See Chapter XXVI.

into the receivables. The whole subject of checking credits is one for another treatise.[28] The credit department, it should be pointed out, like the sales department, has a prob-

OUTSTANDING ACCOUNTS Jan.-Jun. / Jul.-Dec. 19__

Total Outstanding			Jan.31 Jul.31		Feb.28 Aug.31		Mar.31 Sept.30		Apr.30 Oct.31		May 31 Nov.30		Jun.30 Dec.31		Total Outstanding
			$50,972		$44,620		$48,128		$46,686		$41,124		$39,177		
New	Dec		20,000		18,000		22,000		23,000		21,000		19,000	Jun	New
1 M Old	Jun Nov	50	12,500	56	11,000	60	10,800	55	12,100	40	9,200	45	9,450	Dec May	1 M Old
2 M Old	May Oct	38	9,500	20	5,000	28	5,600	30	5,400	20	4,400	15	3,450	Nov Apr	2 M Old
3 M Old	Apr Sep	22	4,400	28	5,500	10	2,500	10	2,000	18	3,240	15	3,300	Oct Mar	3 M Old
4 M Old	Mar Aug	15	2,100	12	2,400	15	4,000	4	1,000	8	1,600	12	2,160	Sep Feb	4 M Old
5 M Old	Feb Jul	6	1,002	6	700	6	1,200	4	1,000	1	250	5	1,000	Aug Jan	5 M Old
6 M Old	Jan Jun	2	500	6	835	2	280	3	600	2	500	1	250	Jul Dec	6 M Old
7 M Old	Dec May	1½	258	8	500	4	568	1	140	1	200	0	0	Jun Nov	7 M Old
8 M Old	Nov Apr	1½	200	½	85	2	300	4	668	1	140	0	0	May Oct	8 M Old
9 M Old	Oct Mar	1½	316	1	160	½	85	0	0	2	334	1	140	Apr Sep	9 M Old
10 M Old	Sep Feb	.5	75	1½	215	1	160	½	85	0	0	1	167	Mar Aug	10 M Old
11 M Old	Aug Jan	1	100	0	0	1	210	1	160	0	0	0	0	Feb Jul	11 M Old
12 M Old	Jul 262	1	225	1	100	0	0	1	210	1	160	0	0	Jan Jun	12 M Old
13 M Old				1	225	1	100	0	0	0	0	1	160	Dec May	13 M Old
14 M Old						1	225	1	100	0	0	0	0	Nov Apr	14 M Old
15 M Old								1	225	1	100	0	0	Oct Mar	15 M Old
16 M Old										0	0	1	100	Sep Feb	16 M Old
17 M Old												0	0	Aug Jan Jul	17 M Old

(Copyright, 1924, K G Karsten)

Form Devised by K. G. Karsten to Keep Analytical Record of Accounts Receivable

lem in balance. If it is too lenient in checking sales, stagnant accounts will result; if it is too drastic, stagnant inventories will result. The proper course is to use due diligence in checking sales promptly—thus aiding sales—and in checking them correctly—thus aiding collections.

The second duty of the credit department is that of collections. Much has been written elsewhere on the subject Here we need merely say that (1) vigilance should be the motive power, (2) courtesy the lubricant, and (3) decision,

[28] See Ettinger and Golieb, "Credits and Collections "

when forceful means are needed, the transmission. Thus will receivables, once they are created, be translated with due celerity into cash.

The best insurance against stagnant receivables is a proper record and analysis that will enable the management to check up the efficiency of the collection department.[29] Several methods of doing this are in practical use, but a discussion of them is not within the scope of this book.[30] However, one aid to efficiency in collections is presented. The form on page 468, filled out with imaginary figures, was designed by Mr. K. G. Karsten, from whom the author received permission to reproduce it here. The chart is arranged to be used for six months, when the figures will be transferred to a new chart. If the chart is being used for the first six months of the year, the first column will represent the situation on the 31st day of January. At the head of each column is the sum of all the amounts shown below; it represents the receivables outstanding during the periods indicated at the head of the column ($50,972). In the row beneath, opposite the word "New," is placed the amount of the credit sales made during January ($20,000). To the right is the amount of sales for February ($18,000), and so on. Below the January sales are the uncollected receivables for December, indicated at the left margin as being one month old. In the small oblique area is placed the percentage (50 per cent) of the December sales uncollected. We know, therefore, that the December sales must have been twice $12,500. If we follow the December receivables, we can see how much remains outstanding, in percentages and amount, each month; thus, on the 31st of January, 50 per cent, or $12,500, were still outstanding; on the 28th of February, 20 per cent, or $5,000, were outstanding, and so on. The advantages of the amount of information arranged for quick comparison contained in this chart will become evident to any one who uses it in actual practice.[31]

We may add a word here, as we did when discussing the purchasing department, on the inter-relations of departments.

[29] For a discussion of credit insurance by credit insurance companies, see Ettinger and Golieb, "Credits and Collections" See also "Insurance Bulletin No 8" of the Chamber of Commerce of the United States

[30] See Gregory, "Accounting Reports in Business Management," Chapter XII.

[31] Mr Karsten has installed the use of this chart in a number of offices, where it is being used with noticeable effect.

Collections will suffer if (1) the sales department is permitted to sell products which the company is not prepared to deliver, or if (2) the production department does not produce goods whose merit is up to specifications. Hence the credit department must report all complaints arising in those departments that tend to stagnate receivables. Moreover, the credit department may actually promote sales by helping weak customers and giving them advice, thus turning customers who may be near the margin of insolvency into active, strong buyers. Mr. H. Uehlinger, a prominent member of the National Association of Credit Men, has done much along this line for his own company and for the credit fraternity in general.[32]

Financial policy in relation to conservation of circulating capital.—In the early part of this book, many devices were shown for reducing the cost of fixed capital. Where a business is fluctuating, fixed charges should not be assumed, for they will cause a drawing off of circulating capital when the circulation is not sufficiently rapid to sustain the fixed charges. High interest-bearing securities should be refunded into low interest-bearing securities when the opportunity offers. The actual cost of financial operations should be kept down, and circulating capital thus conserved, by offering securities that have attributes which will make them readily salable. Here again a nice balance must be achieved between giving new issues the element of marketability and burdening the company with unnecessary future obligations. What is needed is a thorough understanding of all financial devices in order that those may be selected which give the maximum of marketability and the minimum of future obligations. Questions of dividend policy which bear very directly on the problem of working capital will be taken up in a special chapter.

Maintenance of property as a step in conservation.—Circulating capital can easily be dissipated through failure properly to maintain the tangible assets. Insurance must be bought as a hedge against all likely dangers for which insurance can be carried. Repairs should be made to guard against breakdowns, to keep up operating efficiency, and to

[32] See H. Uehlinger's article, "Taking the Risk Out of Poor Credit," *System*, October, 1917, also "Helping the Customer Along the Second Mile of Business," *Printer's Ink*, February, 1924, page 46.

prevent loss of power; replacements must always keep the plant free from obsolete machinery, while additions and betterments must be made to substitute machine process for costly hand fabrication.

Some general rules for administration in the interest of conservation of circulating capital.—The following rules lead too far into the subject of general management to be treated at length; they are set down here as guides to which an executive may refer when checking up the general efficiency of his administration in an effort to reduce the outflow of cash funds. The management should endeavor to:

1. Reduce to a minimum fixed administration expenses in order that the business may be as nearly elastic as are the business conditions affecting the company

2. Base all processes of the business on exact information, properly analyzed and logically synthesized, and applied to future plans.

3. Have the units in the several departments of such size that each department will be used to its full capacity. In terms of simple arithmetic, the whole business should be the least common multiple of the capacities of the several departments. Thus no unnecessary waste will occur in any place.

4. Salvage and turn into cash unnecessary, unproductive, fixed operating assets.

5. Sustain the intellectual and moral elements of credit; the health of the whole personnel, especially that of the chief officers, must be maintained; and above all, the faith of customers, creditors, and employees in the moral integrity of the management must be sustained.[33]

6. Provide a dividend policy that will readily attract new capital.

7. Keep the credit of the company at the bank good for seasonal and emergency demands for cash.

8. Use the supplementary financial agencies when expedient to raise cash by such means.

9. Provide enough initial circulating capital so that every step in expansion may permit the circulating capital to perform its ordinary functions without undue strain.

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[33] Improper tax dodging, nepotism, grafting on a corporate enterprise for personal expenses—all such unethical practices must have their effect on the moral fibre of the entire business In no path of life is teaching by example more effective than in business.

10. Provide ample "regular circulating capital" through the sale of capital stock or bonds or through "ploughing in" of surplus.

11. Keep a cash budget in order to forecast demands for cash funds and the sources from which cash may be derived.

12. Use supplementary services of engineers and economists, and the published services of service institutions as aids in the prevention of unscientific guesswork.

CHAPTER XXIV

WORKING CAPITAL (CONTINUED)

Sources of working capital.—In the previous chapter the nature of circulating capital was described, the elements determining the amount needed in any business were outlined, and the steps that should be taken to conserve it were briefly explained. We are now ready to discuss the sources of working capital. The reader will do well, before proceeding, to turn back and examine the diagrams on pages 374 and 375, and the lower part of the diagram on page 445.

The following is a brief summary of the sources of cash, classified according to the nature of the source:

From the business itself:

1. Regular receipts.
2. Accumulated profits undistributed and invested in marketable securities.

From customers:

3. Discounts for prompt payments.
4. Special sales of ordinary products.
5. Advances on contracts.

From trade creditors:

6. Larger credit lines.
7. Direct loans.

From investors:

8. Stock; exercise of stock purchase warrants.
9. Bonds.
10. Notes.
11. Assessments.

From banks:

12. Loans.
13. Discounts.
14. Bankers' acceptances.
15. Trust receipts and warehouse receipts.
16. Overdrafts.

From note brokers and commercial paper houses:

17. Sales of commercial paper.

From acceptance dealers:

18. Sales of trade acceptances.

19. Sales of indorsed customers' notes.
20. Sales of bankers' acceptances.

From commercial credit houses.

21. Sales of receivables.
22. Pledges of receivables.

From finance companies:

23. Sales of customers' paper secured by property sold to them.

Miscellaneous:

24. Dividends and interest payments on securities held.
25. Advances from affiliated companies
26. Loans from owners.
27. Loans from employees.
28. Loans from friends.
29. Sales of unnecessary fixed assets, including securities.
30. Conversion of fixed assets.

These sources of cash need explanation. It must be noted that many of the items are not true sources of working capital, though they are sources of cash. If a company sells stock, it may increase its working capital and its cash; but if it sells accounts receivable, it increases its cash without increasing its working capital, for in effect it merely exchanges one form of circulating capital for another. In the same way, a loan from a bank increases cash, but does not increase the working capital, for at the same time that cash is increased there is added to the current liabilities the item of bank loans.

Receipts from business.—The chief source of cash in the ordinary conduct of a business is the collection of moneys for goods sold or services rendered. The abundance of cash from this source will depend primarily on the vitality of the sales department and the efficiency of the collection department. If cash accumulates and is not needed for dividends, it may be either (1) invested in good marketable securities that may be sold when the cash is needed, or (2) placed in a special deposit in a bank that will pay interest on it, or (3) turned into a time deposit, or (4) used to purchase a deposit certificate.

Predicting collections.—In order properly to manage the finances, it is necessary that the managers know approximately how much cash may be expected from day to day, week to week, and month to month.[1] A forecast of collections is

[1] See the pamphlet issued by the Boston Chamber of Commerce on "Financial Reports for Industrial Executives" See also McKinsey and Meech, "Controlling the Finances of a Business," Chapter XII.

always predicated on a forecast of sales. Just what the relationship will be, how far collections will lag behind sales, depends upon the circumstances under which the sales were made. Various methods have been suggested for mathematically forecasting receipts from sales, but since the future sales themselves can be only approximations, and since any relationship that is worked out is approximate, the most satisfactory way is probably to take a list of sales or a forecast of sales, make inquiries as to the circumstances under which the sales were or are to be made, make allowances for the business cycle, and set down a logical figure for collections. The plot of collections for the year previous (see page 516) should be available for purposes of comparison, since the present year may be expected to resemble, to some extent, the past year. For further information on predictions of collections, see pages 512 *et seq.*

Cash from customers.—Items (3) and (5), above, are very similar. In some highly competitive fields where selling is seasonal, it is customary for salesmen to get orders much in advance in order to forestall rivals and also to enable their house to judge what its production program should be. It is customary in such cases to give discounts for cash-with-order, although payment is not due till delivery some months later. If the discount offered bears some relation to the length of period to intervene between the advance payment and the actual delivery, and an actual service is rendered by the customers in helping a house to anticipate demand, the practice is not to be condemned. A discount of 1 per cent a month is not unreasonable since, as we saw in the previous chapter, page 462, the ordinary terms of "2/10 net 30" involve interest at the rate of 36 per cent a year, whereas the discount of 1 per cent a month is only at the rate of 12 per cent a year. For example, a concern may sell advertising in an annual directory to be published some time in the future. The price for a certain amount of space may be $100 cash on delivery, 1 per cent discount for cash orders taken one month before delivery, 2 per cent for cash orders taken two months before delivery, and so on.

In times of stress, business houses may change the terms of payment after the sale is made, in order to get customers to anticipate the due date of receivables. The practice is not to be commended, since it raises the question of violation of "one

price" policy and suggests to customers that the house is weak and that better terms may be negotiated than those offered. The difference between the practice outlined in the previous paragraph and this practice is that in the former case the terms are definitely settled before the sale is made and are not subsequently disturbed; there is no urgency; there is only a recognition of the service rendered by the customer in anticipating payment in the latter case, the contract is changed after it has been made.

Special sales.—Sometimes, by special sales, inventories can be turned directly into cash. The practice of "special sales" is quite common in the retail stores of large cities. Such sales usually involve certain lines only. Occasionally, a horizontal cut in prices for all goods will be made. Such a practice may be justified by special events.[2] If the device is tried too often, however, it loses its appeal. The reader will recall instances in which merchants have sought to allay the suspicion that goods were first marked up to be "marked down" by stating specifically in their advertisements that this duplicity has not been practiced.

How Henry Ford raised cash from inventories.—The most notable example of heroic means used to transform inventories into cash was the campaign conducted by Henry Ford in 1920. The story of how Mr. Ford raised cash on that occasion involves some of the principles taken up in other sections of this chapter, but the story is so important and so interesting when told as a connected whole that we give all of it here, and largely in the words of Mr. Ford himself.[3]

I The Problem—General Business Conditions

Our difficulties, like those of other great plants, were a heritage of the war. Our organization suffered along with the rest We took a lot of war work—eagle boats, motors, helmets, tanks and other things This opened up holes in our organization. We needed help in office and shop. Yet in employing we could not be as discriminating as we had been in peace times With war over, we knew that as the country settled back to peace conditions some

[2] A notable instance was the cut of 20 per cent made by John Wanamaker in 1920 The cut was justified, for prices at wholesale tumbled by that percentage in the course of a few months

[3] From an interview in the *Detroit News*, July 22, 1921, by James Swinehart, reprinted in the *Commercial and Financial Chronicle*, July 30, 1921 The text is all in Mr. Ford's own words except where indicated To economize space, we have dropped as many sentences as possible, but to preserve the continuity to the eye, we have not indicated where the sentences are omitted. The order of the topics discussed has been rearranged to give them more logical sequence.

stern readjustments would be necessary. It must come and we were on the lookout for its beginning The first indications came early in 1920—here and there a business or manufacturing failure Soon failures became more general That meant something to us It raised a question—when will the country curtail or cease buying staple commodities? When will they cease buying Ford cars? We did not have long to wait By June sales were falling off at a great rate Everything began to slow down. Yet in the face of that, do you think the suppliers of raw materials would cut their price or that labor would give more for unparalleled wages? Not for a second. Material men demanded more and labor seemed to give less and less Cost of manufacturing went soaring [4]

II. The Problem—Ford's Financial Needs

Back in 1919 we had borrowed $70,000,000 on notes with which to buy out all other interests Of this we had paid back $37,000,000, leaving $33,000,000 still to pay and falling due April 18 Then, because of adjustments pending, we still had the final instalment of the 1920 Federal income tax to pay, which with the instalment due April 15, made $18,000,000 due the Government. Also we intended to pay our men their usual bonus on last year's work, which would amount to $7,000,000 more. So all in all, between January 1 and April 18, 1921, we had to meet obligations totaling $58,000,000 At that time we had only $20,000,000 in cash

III The Wall Street View of the Problem

That, I think, is where the Wall Street bankers went wrong—they couldn't see where we could get $40,000,000 more to meet our obligations. [The story from which this is being quoted opened with a dialogue which it is wise to quote here.]

On a late January afternoon last winter a high-powered motor car rolled up to the door of Henry Ford's home in Dearborn and out stepped a banker, formerly of Detroit, now connected with one of the biggest banks on Broadway.

In answer to his ring, the door swung wide and a moment later he was shaking hands with the motor manufacturer

This banker, according to Mr Ford's associates, was the official emissary of a group of Wall Street banking interests come to offer the manufacturer a loan [5]

"But I do not need to borrow money," Mr. Ford is reported to have told him. "I can finance all my companies' operations myself"

"I think not," the banker confidently went on. "We know your obligations, we know your cash reserves and we know you need money. Now I have written out here a plan by which we can assist you. I would like to read it to you."

The manufacturer is reported to have told him his effort would be a waste of time and breath, but if he still wished to read his proposition, he might do so. The manufacturer would do him the courtesy of listening

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[4] See pages 320 and 333 for charts of business activity and failures

[5] It will be seen later that the Ford plant was shut down for six weeks This move in Ford's strategy was accepted apparently by the bankers as confirming their belief that Ford's "back was to the wall"

The reading went on for several minutes Then the banker, suddenly breaking it off, asked "Who's going to be the new treasurer of your company?" (The former treasurer had recently resigned)

"That makes no difference to you, does it?" the manufacturer answered.

"Oh, yes, it does," the banker came back. "We'll have to have some say as to who the new treasurer shall be "

That remark closed the interview

"I handed him his hat," said Mr Ford, "showed him where the door was and told him to take his things and get out right quick The next time I saw Edsel I told him that, in the future, he was to be the treasurer as well as president of the Ford Motor Company "

IV. The Solution—(a) Cut in Price of Cars and Forcing Reduction of Price of Supplies

It was up to us to do something So, in September, we cut the price of the car On the face of things the cut was not justified. We still had large supplies of stock bought at high prices.[6]

The cut brought the price below the cost of manufacture. To an extent the cut brought the desired result. But soon sales fell off again We soon saw that more drastic treatment was needed

We kept right on, full tilt. Sales did not justify our large production, but we kept on making 90,000 to 100,000 cars a month because, when the halt came, we wished to have as much as possible of our stock manufactured into cars We wanted the next bump, when it came, to be one that no one selling us supplies could fail to understand.

Now, to see what happened, you must understand that our company buys in tremendous quantities. Right now we are buying $50,000,000 worth of materials a month There are hundreds of concerns from which we take the major part of their output Back of them are other firms, who sell the greater part of their output to the suppliers from whom we buy. So when we pull the switches in the Ford plant and stop our machinery the same thing happens in thousands of smaller plants the country over

It's just like when you stand dominoes close together in a row—if you knock over the first one, the whole line falls. As long as we kept on buying, these plants would continue to hold prices up. Some of them did cut, but on the part of most of them, we felt, it was only a bluff to make it appear that they had reached the new low basic price for peace times

We saw that if the lowering process was to be hastened at all we must do something drastic So, late in December, we closed down, resolved not to resume production until we could buy materials at peace-time prices, and in the meantime to have a thorough house-cleaning. We thought it would require but two weeks, as it turned out, it required six.

V. The Solution—(b) Forced Sale of Finished Products

When we closed down we had on hand approximately 93,000 finished cars. At Highland Park we had been shipping out cars and parts to dealers

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[6] Ford reduced the value of his inventories, carried at $105,000,000, to $88,000,000 and in so doing removed fear of the future by an act of immediate courage

and branches as fast as they were finished. This plant was cleared of materials. Every department closed down

But we have thirty-five branches scattered over the country, at twenty-two of which we both manufacture parts and assemble At these the manufacturing of parts stopped, but the assembling of finished parts went on, adding week after week through January to our finished cars

Our first move was to sell some of our cars on hand In our contracts with dealers they agreed to take a certain quota each year, each according to his district We shipped to each dealer enough cars to take care of approximately twenty-five days' sales During January we sold nearly 60,000 cars, which showed us what we could do when we tried, and from then on sales steadily mounted above production Assembling went on at all the branches, and on January 23 we reopened the Highland Park plant and began building up production there But still sales kept ahead of production Between January 1 and April 1 we turned $24,700,000 worth of stock into cash [7]

VI. The Solution—(c) Turning Miscellaneous Assets into Cash

Then we looked over our foreign accounts and found our agents at foreign ports owed us $3,000,000, which we collected. We had also sold by-products, for which we had accounts receivable of $3,700,000 more, which we got in On top of that we sold $7,900,000 worth of Liberty bonds

If you total those, you will find they come to $59,300,000, more than enough to meet our impending obligations (In this total, Mr. Ford included, of course, the $20,000,000 cash on hand January 1.)

VII. The Follow-up—(a) Economies in Transportation

But we did not stop there The war had led us into many extravagances of administration and accounting We went through the plant, offices and shops, and made economies, eliminating everything non-productive

Before we got control of the D T. & I. (Detroit, Toledo & Ironton Railroad) it required an average of 22 days to haul raw material to the factories, make it into cars and get them to the dealers We had to buy three weeks in advance of need, with no way of knowing future conditions We had to keep immense reserves on hand. The money tied up in those and the goods moving stood continuously at about $88,000,000

[7] The story of how Ford pushed his dealers is told in the *New York Times*, July 24, 1921, as follows:

Ford pushed his 125,000 surplus automobiles up the hill, off his inventory account and into the hands of 17,000 dealers. He shipped automobiles right and left all over the world to willing and unwilling consignees and drew against them

Mr Ford came East and found some $91,000,000 in "frozen" cars and parts in the New York, Philadelphia and Boston districts Changes in personnel followed and others were threatened The cars began to move out

The case was reported of an Indiana dealer who had a floor full of Fords His consternation was great when a trainload of cars, unordered, rolled into the city His business future was at stake He must, and did accept the draft A former disgruntled Ford dealer with superior resources bought the trainload and startled the countryside by advertising a bargain sale of Ford cars

In other cities and towns the dealers went to their banks and borrowed on the cars Shipments averaged about one-tenth of a year's business The unloading plan was a success, because it was economically sound Agents were bluntly told that they were indebted to the Ford Company and that to prosper in the future they must assist now Those who rebelled were removed Those who accepted are to-day the strongest proponents of the Ford method

But the early months of 1921 brought great changes General cessation of industry made materials and cars in which to carry them, plentiful. Then the D. T & I is really one great terminal—it crosses every transcontinental line in the country. When stock consigned to us reaches the D. T. & I. it can be speeded along to its destination.

Then in the offices of the D T. & I. they did away with a deal of antiquated railroad red tape Whole systems of useless accounting were abolished The offices themselves have been brought to Detroit and the road is operated as a single unit[8] All these elements combined have reduced the time of our movement of stock from the suppliers of raw materials through the factory and the cars into the hands of the dealers from 22 to 14 days, and that isn't the end—we'll cut it still more.

Where, before, we had $88,000,000 tied up in moving and reserve stocks required to make 93,000 cars a month, now we handle the stock required to make 114,210 cars a month for less than $60,000,000. Thus $28,000,000 goes into cash account, to be used for other purposes—as paying debts, for example.

VIII The Follow-up—(b) Reducing Cash Tied Up in Inventories

But there is another angle to that Able to get stock so much more rapidly, we do not have to keep so much on hand Formerly we bought in vast bulk lots, using up stock as we needed it. We have worked out a new system, which I believe is not duplicated anywhere.

There are 8,000 parts to the Ford car. Each one of those parts is given a number symbol Once each month we make a schedule of the exact number of cars we will make the next month. Then we figure out the exact amount of stock needed to make just the number of parts to fill that schedule, and buy that amount of stock and no more We are following my father's advice and not loading up with things we don't need.

IX. The Follow-up—(c) Reducing Overhead

Office and shops also came in for a house-cleaning. We went through the offices and cut out hundreds of jobs created during the handling of war work. We literally took out a trainload of desks and furniture and sold them[9] We told the men that occupied those desks that back in the shops were plenty of good jobs at good pay—if they wanted to take them. Most of them did.

We cut the office forces from 1,074 to 528 persons. Telephone extensions were cut about 60 per cent. Interesting and useless systems of statistics were abolished, as well as the forms made necessary by them.

We went through the shops in the same way. During the war production we had a foreman for about every three to five men. Too many foremen sat at desks all day long looking on We have sold all the desks, and

[8] In June, 1929, Pennroad Corp acquired control of the company by purchasing stocks and bonds owned by Henry Ford and associates.

[9] If we are to believe S S. Marquis' "Henry Ford,"—Mr Marquis was formerly the rector of Mr. Ford's church and knew Ford well—on occasion, Mr Ford smashed the desks instead of selling them, and by this means informed the supernumeraries that their services were not needed.

most of the former foremen are now at machines. We now have a foreman to about every twenty men Everything and everybody that were not producing were put in a position where they could produce or were eliminated

A comparison of our operating costs before and after the house-cleaning is really a startling lesson in what manufacturers can do if they look sharp to economy Big plant or little plant—the same thing can be done and the same methods will win every time. Back in November, 1920, before the house-cleaning, our daily expense for labor and commercial overhead charges, cost of materials not included, averaged $465,200 to get out an average of 3,146 cars a day, or $146 a car. Look what we do in June, 1921 —$412,500 a day to produce an average of 4,392 cars a day, or $93 a car.

Cash from creditors.—The size of a loan or of a sale on credit allowed by dealers depends largely on the same considerations that affect the size of a bank loan; these we shall discuss presently. In certain lines of business, as in some branches of the textile trade, material men and equipment houses often make direct loans to customers. The justification of the practice is that it helps meet competition and enables the customer to increase his purchases.

Bank loans and discounts.—The average industrial concern relies chiefly on the commercial bank for assistance in meeting the demands of variations in cash requirements;[10] the bank may make a direct loan on the borrower's own note, or may in effect make the loan by discounting the notes or accepted drafts or trade acceptances of the borrower's customers. No business man can call himself competent who does not understand the principles on which banks operate and especially those principles which govern the extension of credit to customers by banking houses.[11] The more important questions we shall briefly outline.

In the first place, the business house must select its bank carefully, establish its right to loans, and keep its credit good by conducting its business properly and giving the bank full information on how its business is being conducted. In passing, it ought to be said that recourse to banks is a decided tonic. The business man who needs to borrow from a bank will know that he and his business are to be subjected to searching inquiry and the consciousness of that examination

[10] Under the Act of June 19, 1934, direct loans may be made to industry by Federal Reserve banks if the borrower has been unable to obtain requisite financing on a reasonable basis from the usual sources

[11] See J A Fitzgerald, "Making Use of a Bank"; J D. Magee, "Materials of Banking"; W. H Kniffin, "The Business Man and His Bank"; Harr and Harris, "Banking Theory and Practice."

stimulates efficiency When a corporation borrows from a bank, the bank watches its financial operations with great care and frequently makes suggestions that are of inestimable value to the general welfare of the corporation. Such suggestions may take the form of a warning that a dividend should be passed, or that a bank loan should be increased in order that the corporation may take greater advantage of trade discounts. Then, too, using a bank's facilities makes a favorable impression on supply creditors; the latter are usually more ready to be liberal with customers who regularly borrow from a bank, for they know that the bank loans could not have been obtained if the customer had not met successfully the bank's investigation.

Sometimes several banks will be used, especially where plants are maintained and important selling operations are conducted in different localities.[12]

Choosing a bank.—Questions that a prospective customer may ask about a bank are: (1) What is the reputation of the bank as to strength? The business house seeks first of all a strong bank. The business man should be able to make an intelligent analysis of the financial statement of the bank to satisfy himself that the bank is in a position to meet its obligations to depositors. (2) How large is the bank? In small communities the capital and surplus may be so small that the limit of credit to one concern—approximately one-

[12] Where branches are permitted to keep their own balances, considerable cash may be tied up without bearing its share of the burden of earning profits Mr Alfred H Swayne, vice-president of the General Motors Corporation, tells how his company reduced from $10,000,000 to $4,000,000 the "float" of cash caused by checks in transit between plants, by establishing "central reservoirs and a system for handling the cash deposits of all units by telegraph "

Mr Swayne's description follows

The sales companies deposit in local banks, which are instructed to cooperate in an automatic system of remittances to the Treasurer of General Motors Corporation A fixed minimum and maximum are determined for each local deposit account, and when the deposits rise above the fixed maximum the excess above the fixed minimum is transferred by the bank to New York through the Federal Reserve Bank, which has what is probably the finest private telegraph system in the world Those transferred amounts are then credited to General Motors at one of the dozen New York and Detroit banks in which the Corporation maintains deposit accounts

By telephone or telegraph the Treasurer is notified by the banks of each new credit item The next act may be to transfer through correspondent banks by the Federal Reserve telegraph system the whole or any part of the credit to banks in any of the 33 cities in which there are plants having disbursing accounts For example, deposits at Atlanta may go above the stated maximum at 10 o'clock in the forenoon In two or three hours the transferred amount may be available for a manufacturing subsidiary in Detroit, Lansing, or Flint, to check against

The service thus rendered the 71 divisions and subdivisions resembles very closely that performed by the Federal Reserve System for the national banks of the country —*Management and Administration*, January, 1924

tenth of capital and surplus[13]—may be insufficient for the purposes of the business. In such cases the local bank may be used simply for day-in and day-out convenience and a large line of credit may be established with a metropolitan bank. (3) Is the bank conveniently located? While the practice of keeping accounts at more than one bank is not to be recommended ordinarily, circumstances may arise to justify it. Sometimes the checks deposited are small and numerous and can be handled at a lower cost by a country bank. The author knows of one case where such checks are sent by mail to a country bank, whereas the local city bank is used for keeping funds to pay the accounts payable. In this way the concern's creditors get their information as to credit risk from a large well-known city bank, and the impression thus made is more favorable than if the concern gave the country bank as a reference. (4) Are there any reasons why the directors of the bank should not favor the concern? They may have business associations with competitors, or may not be familiar with the business; in such an event, the bank should not be used. (5) What is the disposition of the directors; are they ultra-conservative; will they be fair during a period of general business stress; will they be helpful and co-operative? (6) The question may also be asked. is the bank equipped to give necessary special service, such as aid in foreign trade? Banks in the large cities are gradually specializing in certain fields, such as textiles, furs, and so on. It seems that this practice, while it enables the bank to understand the customers' business better than is the case where miscellaneous accounts are kept, tends to concentrate demands for accommodation and thus to reduce the "line" which may be extended to each customer. In the final analysis the true test will be experience, do not wait to make an approach to the bank till the day before the loan is needed.[14] Other facilities for special service, such as for safe-keeping of securities, for collecting coupons, for rendering service in respect to income tax returns, and for keeping the customer informed of conditions in a particular industry, may influence a company in the choice of a bank.

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[13] See J. A Fitzgerald, "Making Use of a Bank," pages 168–173

[14] See W H Kniffin, "The Business Man and His Bank," especially Chapters III and XXI.

Tests of credit standing with a bank.—It is well for the business man always to keep in mind the principal subjects of inquiry on which a bank relies when investigating an applicant for a loan A brief outline will suffice.

1. What are the character and ability of the owners? What has been the bank's experience with the directors and officers of the company? Is the relationship between the managers and the employees good?

2. What is the capacity or capital of the business?

3. What is the earning capacity of the business? Is it a progressing or a declining business?

4. Are earnings being properly used? (The bank can get much information by watching the checks debited to the concern's account.) Does the firm take advantage of trade discounts and cash discounts? What is its reserve, dividend, and surplus policy? Is it adequately protected by insurance?

5. Can the concern furnish a recent financial statement? When are financial statements made? What about the items in the financial statement? For example, how is the inventory valued? When is the inventory largest?

6. Does the concern keep a reasonable bank balance? The general rule is that a foundation for maximum bank loans must be laid by maintaining a deposit balance equal to from one-tenth to one-fifth of the maximum loans, depending on circumstances. If a concern does not have many items for collection, and is therefore not costing the bank much, a relatively smaller balance will be satisfactory.

7. Does the concern maintain a reasonable margin of current assets over current liabilities? The banker's rule is "2 to 1," that is, two dollars of current assets for every dollar of current liabilities. It should be understood, however, that this rule must be modified when circumstances warrant.

8. Is the concern properly financing fixed assets; that is, are the funds raised for investment in fixed assets ownership funds—contributions of capital by partners, proceeds of corporate stock—or the proceeds of funded indebtedness that will mature at a reasonably distant future date, or are they the product of current liabilities and should they therefore be used for current purposes only?

9. To what extent does the company use banks, trade houses, and commercial paper houses in borrowing capital,

and what is the standing of the company with these lenders? When are its borrowings heaviest?

10. What is the purpose of the loan applied for; does it seem reasonable in view of the general business conditions, the seasonal situation in the particular line of business, and the trend of events within the business itself?

11. Has the business in the past met its obligations promptly, and is it in position to clear itself of bank debts periodically? The true function of a bank is to meet periodic or special variations in circulating capital; minimum requirements, if not met out of regular cash income, should be supplied by the owners or through long term loans—bond issues—that can be negotiated at a lower rate of interest than bank loans. Since a business rarely withdraws from deposit more than 80 per cent of a bank loan, the rate of interest on the actual funds used is 25 per cent higher than the nominal rate. Thus, if $1,000 is borrowed at 6 per cent and only $800 is withdrawn and used for the year, the actual rate of interest ($60) paid on the $800 is 7½ per cent. The rate is not abnormal for seasonal capital, but ordinarily it is too high for circulating capital that is to be used year-in and year-out, that is, regular circulating capital as described in the previous chapter.[15]

12. How is the company rated by the credit rating agencies?

In analyzing the financial statements of a business which is making application for a loan, banks reduce certain items in the statements to ratios, and compare these ratios with ratios found to be existing in successful companies engaged in the same line of business, and with ratios of the same company over a number of years. It is well for the business seeking credit to be familiar with these ratios and with their meaning.[16]

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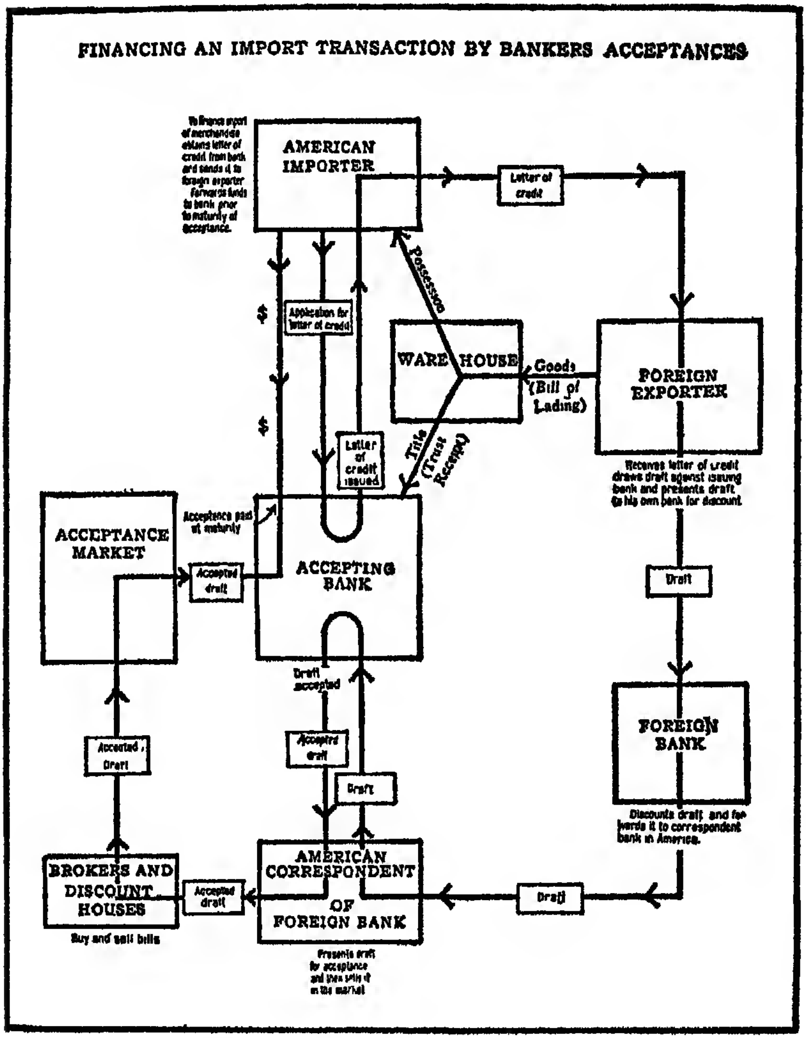
[15] See the discussion of this point, pages 449 *et seq*

[16] The ratios in most general use are (1) the current ratio, (2) the "acid test," which is the ratio of circulating capital, less merchandise, to current liabilities, (3) receivables to merchandise, (4) sales to inventories (merchandise), (5) sales to receivables, (6) sales to bills and accounts payable, (7) sales to net worth, (8) sales to fixed assets, (9) worth to fixed assets, (10) worth to debt. The three ratios most generally applied in determining the extent of a loan are the current ratio, the acid test, and the worth to debt ratio. We cannot, for lack of space, go into a discussion of these ratios here, and we therefore refer the reader to James B Trant, "Bank Administration" for an explanation of how the ratios are determined and what they mean See also Wall & Duning, "Ratio Analysis of Financial Statements," and Walter Rautenstrauch, "The Successful Control of Profits"

Acceptances and collateral receipts.—Banks make loans with or without collateral. In the latter case the usual practice involves merely the delivery of the borrower's note



FINANCING AN IMPORT TRANSACTION BY BANKERS ACCEPTANCES

Adapted from a diagram prepared by the Federal Reserve Board. These changes have been made: The foreign units have been put on one side (at the right) and the domestic on the other, the warehouse has been added to show the relation of the trust receipt in handling the goods. See explanation of trust receipt, page 491, application for letter of credit, page 487, and letter of credit, pages 488–490.

for the amount of the loan, whereupon his account is credited with the face of the note less bank discount. Sometimes notes of the borrower's customers are indorsed over to the bank, that is, the bank discounts the borrower's notes receivable. The practice has grown, though not without encountering resistance and even some opposition, of using

Guaranty Trust Company of New York

APPLICATION FOR LETTER OF CREDIT

Guaranty Trust Company of New York,
Foreign Department, Commercial Credits Division,
New York City, N Y

Please issue an Irrevocable Letter of Credit and transmit same by cable / mail / airmail

In favor of ____ (Name) ____ (Address)

For account of ____

Amount ____ Available by drafts at ____ (Sight, thirty, sixty, or ninety days)

against documents as follows

Bills of Lading reading "Received for Shipment" or otherwise worded to same effect are acceptable against this credit

Ocean bills of lading
Commercial Invoice
Consular Invoice (with Statistical Copy attached)
other documents ____

evidencing Full / ____% invoice value of C I F, - C & F, - F O B, - F A S - Shipments of ____ (Cross out all but one)

from ____ to ____

Drafts to be negotiated on or before ____

Marine and War Risk Insurance to be effected by ____ (Shipper or Purchaser)

Partial shipments are to be permitted.

Special Instructions ____

The Letter of Credit is subject to your usual terms and conditions, and in consideration of the issuance thereof we hereby agree to reimburse you on demand, and we hereby authorize you to charge any accounts we may have with you with any and all amounts for which you are liable thereunder, plus your commission and charges As security for the total of this credit and your obligations thereunder, and for the performance of any and all of our obligations hereunder, you are hereby given a lien upon and/or right of set off in respect of any and all property or money held for, belonging to or in said accounts now or at any time with you, and we hereby agree to deposit and pledge with you such additional collateral as may from time to time be demanded.

Neither you nor your correspondents shall be responsible for the description, quantity, quality or value of the merchandise shipped under this credit nor for the correctness, genuineness or validity of the documents, nor for the general or particular conditions stipulated in the documents, nor for delay or deviation from instructions in regard to shipment, or for any other cause beyond your control.

In the event that you may entrust any of the goods, merchandise or documents relating to this credit to the undersigned or their agents, the undersigned agree to sign and deliver to you on demand a trust receipt as defined in and complying with the requirements of Article 3-A of the New York Personal Property Law and a Statement of Trust Receipt Financing in the form specified in said Article

The Guaranty Trust Company of New York does not assume responsibility for any inaccuracy, interruption, or delay in the transmission or delivery of messages by cable and/or by mail

____ (To be signed by properly authorized official)

Application for Letter of Credit

trade acceptances. If *A* sells goods to *B*, he will "draw on" *B*, *B* will accept the draft, and *A* will then negotiate it at the bank. One advantage of this system is that the bank may rediscount the draft at one of the twelve Federal Reserve banks.[17]

Guaranty Trust Company of New York

Foreign Department

Letter of Credit No 140 Broadway New York,

Gentlemen

We hereby establish our irrevocable credit in your favor for account of

available by your drafts drawn at on the

Guaranty Trust Company of New York, 32 Lombard Street, London, E C

for any sum or sums not exceeding a total of

accompanied by commercial invoice, consular invoice (with statistical copy attached), ocean bills of lading

evidencing shipment of

SPECIMEN

Insurance

Ocean Bills of Lading must be drawn to the order of

A COPY OF THE CONSULAR INVOICE (WITH STATISTICAL COPY ATTACHED) AND ONE BILL OF LADING MUST BE SENT BY THE BANK OR BANKER NEGOTIATING DRAFTS DIRECT TO THE GUARANTY TRUST COMPANY OF NEW YORK, NEW YORK AND A CERTIFICATE TO THAT EFFECT MUST ACCOMPANY THE DRAFTS

The amount of each draft negotiated, with the date of negotiation, must be endorsed hereon

All drafts drawn under this Credit should bear the clause "Drawn under G T. Co of N Y Letter of Credit No dated New York,

We hereby agree with bona fide holders that all drafts drawn by virtue of this Credit, and in accordance with the above stipulated terms, shall meet with due honor upon presentation and delivery of documents as specified to the Guaranty Trust Company of New York, London, if drawn and negotiated on or before

Yours Respectfully,

Authorized Signature

Assistant Manager
Assistant Secretary

Letter of Credit

[17] See E E Lincoln, "Applied Business Finance," pages 455 *et seq.*, for a statement for and against the use of trade acceptances See W. H. Steiner, "The Mechanism of Commercial Credit," for a history and general discussion A very complete discussion of the "pros" and "cons" will be found in the "Trade Acceptance Catechism," compiled by Dr. J. T. Holdsworth for the American Trade Acceptance Council, Woolworth Building, New York City.

Guaranty Trust Company of New York,
140 Broadway,
New York, N Y

Dear Sirs

In consideration of your opening from time to time at your option and at the request of the undersigned your Letters of Credit (hereinafter referred to as "Credit"), we jointly and severally hereby unconditionally promise and agree as follows:

1 As to drafts drawn under said Credit payable in United States Dollars the undersigned agree to provide you or your designated agents with United States Dollars in New York at least one day prior to the maturity of any bills drawn under said Credit or drafts and/or other instruments executed in renewal thereof to the amount thereof, or if any such bills shall be drawn payable at sight, then to provide such funds immediately upon receipt of notice of payment thereof

2 As to drafts drawn under said Credit payable in a currency other than United States Dollars the undersigned agree to provide you and/or your designated agents with funds prior to maturity at a time to be determined by you, sufficient to cover the amount of such drafts, in the form of bankers demand bills of exchange, to be approved by you, payable in the currency of such drafts and bearing our endorsement, or at your option, to provide you with the equivalent in United States Dollars, of any such drafts drawn at your then selling rate for check remittances to the place of payment in the currency in which such drafts are drawn, or if any such drafts be drawn payable at sight, then to provide you immediately upon receipt of notice of payment thereof, with the equivalent in United States Dollars, at your then selling rate for cable transfers to the place of payment in the currency in which such drafts are drawn

3 The undersigned also agree to pay you, on demand, your usual commission together with interest where chargeable, all expenses and sundry charges incurred by you in connection with said Credit

4 The undersigned undertake to insure against the usual risks as required by you all the goods and merchandise shipped under said Credit, in companies and form satisfactory to and approved by you, and on your demand to deposit with you such policies so drawn or so assigned or endorsed that all loss occurring thereunder shall be payable to you and to be delivered to you and notwithstanding any such approval the undersigned assume all responsibility as to the sufficiency and genuineness of the insurance and the solvency and responsibility of the insurers The undersigned further undertake to procure promptly any necessary import and export or other licenses for the import or export or shipping of the property and to comply with all foreign and domestic governmental regulations in regard to the shipment of the property or the financing thereof, and to furnish such certificates in that respect as you may at any time require

5 The undersigned agree that the title to all property which shall be purchased or shipped under or by virtue of said Credit, the bills of lading and all evidences of title or possession or other documents relating thereto, the policies of insurance and the proceeds thereof, shall be and remain absolutely in you until payment of the bills above referred to and any and all other sums of money payable on said bills or otherwise and until due payment of any and all other indebtedness now existing or hereafter created or incurred by the undersigned to you in respect of any and all other transactions heretofore or hereafter had with you The undersigned agree to sign and deliver to you on demand a trust receipt, as defined in and complying with the requirements of Article 3 A of the New York Personal Property Law, and a Statement of Trust Receipt Financing in the form specified in said Article, it being further agreed that your rights specified herein shall be in addition to, and not in limitation of, your rights under said Article, or under any other applicable statute

6 Goods and merchandise imported under said Credit shall be paid for, or at your option security approved by you shall be lodged with you before the undersigned shall be entitled to the surrender or delivery of the documents in respect thereof, which security may be retained and held by you until payment of all moneys hereinbefore referred to and as security for which you are entitled to hold the said documents, and in the event that you may entrust the undersigned with any of the said goods or merchandise, the undersigned consent that you may at any time, in your discretion, repossess yourselves of said goods and merchandise

7 The undersigned agree from time to time upon your demand to deliver, convey and transfer to you as security for all indebtedness or liability of the undersigned to you at any time existing or contracted under this agreement or otherwise collateral security of a value and character satisfactory to you, and that you or your agent may hold any goods merchandise, moneys, deposits or other securities of any kind and nature in your possession or under your control as security for all indebtedness or liability of the undersigned to you The undersigned hereby consent that any and all property deposited with or received by the Trust Company as collateral hereunder may be removed by the Trust Company from the State or Country in which it may be held or deposited to any other State or Country, and may there be dealt with by the Trust Company as hereinabove provided It is also agreed that the Trust Company may at any time transfer into its own name or that of its nominee, securities in registered form held as collateral security

8 In the event of any default in payment of any moneys due and owing to you, or in default in the due observance and performance of any matter or thing herein provided for, or in the event of the insolvency of, or the filing of a petition in bankruptcy by or against, or the filing of a petition for reorganization of the undersigned under the bankruptcy laws, or the making of an assignment for the benefit of creditors by, or the application for the appointment, or the appointment, of any receiver of, or of any of the property of, or the issuance of any warrant of attachment against any of the property of the undersigned, or upon the issuance of any execution at law against the property of the undersigned or the commencement of any proceedings under Article 45 of the New York Civil Practice Act, then and in any such event, the whole of the said moneys owing to you by, together with all obligations of the undersigned shall forthwith become due and be payable without presentation, demand or notice which are hereby waived Thereupon, you or your agent are authorised without previous demand, to sell the whole or any part of the said goods and merchandise, shipped or to be shipped under said Credit, or sell the same "to arrive", and may also sell without notice of any kind any or all securities deposited with you at public

Letter of Credit Agreement (Page 1)

or private sale, applying the proceeds, less the costs and expenses of such sale and any other expenses paid or incurred in respect of said goods, to and towards any indebtedness of the undersigned to you, paying the surplus to the undersigned, or the latter's legal representative If any deficiency shall arise, the undersigned will pay the same to you on demand At any *such sale you may become the purchaser and hold the goods or security, free of any right of redemption*

9 The undersigned agree that should the beneficiary under said Credit, upon receipt of advice by cable, or otherwise, of the issuance of said Credit, but prior to its actual receipt, negotiate drafts by virtue of such advice, such negotiation shall be considered a proper one and shall be included under the terms and subject to all conditions hereof, and in addition thereto the undersigned assume all the risk of the misuse of the said Credit The undersigned further agree that neither you nor your correspondents shall be responsible for the form, sufficiency, correctness, genuineness, falsification or legal effect of any documents or papers provided for or mentioned in said credit, or for the description or mis description, quantity weight, quality, condition, packing, delivery or value of goods represented thereby, or for the general and/or particular conditions stipulated in the documents, or of the property represented thereby, or purporting so to be, or for the good faith or acts of the consignor or any other person whomsoever, or for the solvency, standing, etc of the carriers or insurers of the goods, or for the breach of any contract between the users of the credit and the undersigned Furthermore it is understood neither you nor your correspondents assume any liability or responsibility for the consequences arising out of any error, interruption, delay, mutilation or other errors, and/or loss in transit of cables or telegrams, letters and/or documents arising in connection with said credit or any transaction thereunder, or for errors in translation or interpretation of technical terms The foregoing shall not be a defense against any obligation under this agreement and the undersigned will indemnify and save you harmless from all loss and liability however arising from or in connection with the said credit It is understood that we assume all responsibility for all obligations imposed upon you or your correspondents by foreign laws customs and regulations It is also understood that neither you nor your correspondents assume any liability or responsibility for consequences arising out of the interruption of business either by a decision of the public authority or by strikes, lockouts, riots, wars, acts of God or other causes beyond your control

10 The undersigned further agree that the date of any bill of lading shall be conclusive evidence that the goods therein referred to were actually shipped on or before such date and that unless the terms of said credit specifically require "on board" bills of lading the term "received for shipment" or "alongside bills of lading" shall be equivalent to "shipped" or "shipped on board", and shall be conclusive evidence that such goods were shipped on the vessel named in such bill of lading It is further agreed that "through bills of lading" issued by steamship companies or their agents will be acceptable and that bills of lading indicating transshipments will also be acceptable unless direct shipment is specified in said credit Bills of lading mentioning stowage on deck are acceptable on condition that the insurance covers the risks arising therefrom Unless insurance policies are specifically required by the terms of the credit it is agreed that you may accept certificates of insurance issued by companies or their agents or by insurance underwriters Unless specific instructions are given as to the risks to be covered, you or your correspondents may accept insurance documents as tendered provided they cover the goods against ordinary marine insurance risk When other documents are required such as warehouse receipts, delivery orders, consular invoices, certificates of origin, certificates of weight, of quality or of analysis without further definition, you or your correspondents may accept such documents as tendered without responsibility on your part

11 In case the undersigned consent to any overdrafts under said Credit or authorize payment or acceptance of drafts drawn thereunder with irregular documents attached thereto, or authorize or consent to any departure from the terms of the Credit, this agreement shall be fully binding upon the undersigned in respect to such overdrafts, and notwithstanding such overdrafts, irregularities or variances, this agreement and your title to the documents, merchandise and insurance policies shall be, subsist and remain as though all matters had been done in strict compliance with said Credit

12 The obligations of the undersigned and all of your rights under this Credit or the provisions of any trust receipt issued in connection herewith shall be extended for the full period of any advances made or any drafts or acceptances issued, in renewal or extension of any drafts or bills drawn hereunder and shall continue until full payment thereof has been made, whether the obligors and drawers under such extension or renewal drafts shall be the same as under prior bills or drafts or otherwise

13 This agreement is to remain in force and be applicable to all transactions, notwithstanding any change in the composition of any firm or firms, parties to this contract, or users of this Credit, whether such change shall arise from the accession of one or more partners or from the death or secession of any partner or partners

14 We hereby represent that this agreement is without limitation as to duration or amount and the Guaranty Trust Company of New York may continue to act on the faith thereof until such time as said Trust Company shall receive written notice of its withdrawal, which notice or any refusal on the part of Guaranty Trust Company of New York to grant further credits, extensions or indulgences of any kind, will not in any wise affect any Credits theretofore made or obligations or liabilities theretofore incurred, whether then due and payable or thereafter to become due and payable

15 It is agreed that you shall not be deemed to have waived any of your rights hereunder unless you shall have signed such waiver in writing No such waiver, unless expressly so stated therein, shall be effective as to any transaction which occurs subsequent to the date of such waiver, nor as to any continuance of a breach after such waiver

16 It is agreed that all rights arising hereunder shall be determined according to the Laws of the State of New York.

Dated, the .... day of 19

....

....

Letter of Credit Agreement (Page 2)

Sometimes extensive loans are made by the use of "bankers' acceptances." A banker's acceptance is an accepted draft on a bank. If, for example, a manufacturer in New York wishes to sell to a merchant in Texas, he may send the bill of lading to the merchant's bank with a draft on the bank; the bank will accept the draft, which becomes a banker's acceptance. It is easily negotiable because the bank is liable, and is readily transferable in the discount market [17a]

When a bank loans on collateral, the documents ordinarily used are the warehouse receipt, the bill of lading, and the trust receipt. Sometimes investment securities are used to secure bank loans, but such loans in ordinary business transactions are relatively rare.[18] A warehouse receipt or a bill of lading held by a bank gives the bank the right to be reimbursed out of the sale of the goods if the loan thereon is not paid. In each case neither the lender nor the borrower has actual possession of the goods. In the case of a trust receipt the borrower actually has possession of the goods but holds them, or their proceeds, for the account of the bank [19] The theory

[17a] See H. P Balabanis, "The American Discount Market," for an explanation of the organization of the discount market, the service it renders in the financing of domestic and international trade, the opportunities it offers for short-term investments, and the part it plays in the mechanism of commercial credit

[18] Banks prefer secured loans unless the financial standing of the borrower is extremely high The collateral to be offered can be judged on the basis of its known value and, therefore, securities that are quoted on the exchanges are preferred to securities the salable value of which cannot be exactly ascertained but can be approximated only after investigations of the issuing companies For form of collateral note, see C W. Gerstenberg, "Materials of Corporation Finance," pages 905–6

[19] "A person or corporation in this country desires to purchase from a merchant in a foreign country $25,000 worth of chemicals Not having the money to pay for the goods, but expecting to sell them at a profit or to use them in manufacture, the importer goes to the bank and makes a contract whereby the bank agrees to extend to the importer the necessary credit to pay for the goods upon their arrival by accepting the draft drawn for the purchase price upon presentation of the same with the bill of lading, consular invoices, etc The bill of lading carrying the right to the possession of the goods either passes by indorsement in blank or is made to the order of the bank giving the acceptance When the goods arrive and the papers are presented, if everything appears in satisfactory form, the bank accepts the draft presented for the purchase price of the goods and receives the documents entitling the holder to their possession The bank then notifies its customer, the importer, who calls at the bank for the purpose of carrying on the transaction. Up to this point it will be noted that neither title to nor possession of the goods has at any time come to the importer, the intended ultimate purchaser. It is the importer's and not the banker's business, however, to dispose of or to use the goods which are now in this country, and in order to do so, he must necessarily have possession of the same The bank therefore delivers to him the bill of lading so that he can obtain the goods, but

is that the bank, through the trust receipt, has ownership of the goods in the event of trouble.[20]

As was implied in the previous paragraph, the warehouse receipt gives better protection than the trust receipt, since it does not leave possession of the goods with the lender. However, the removal of goods to a warehouse is frequently troublesome and expensive. Recently a new form of service to meet the situation has been developed, by means of which the warehousing is done on the premises of the lender. A warehousing company takes a lease of a part of the lender's premises, on which it displays its sign as occupant. The lender makes written application for storage therein, and a representative of the warehousing company signs and issues warehouse receipts to cover the deposited goods and then takes custody of them. Goods are released only upon surrender of the warehouse receipt or upon proper notice from the bank ordering partial release. The bank then has the guarantee of the warehousing company that the goods will not be improperly disposed of. Since the agents of the warehousing company are bonded against "any act or acts of fraud, dishonesty, forgery, theft, larceny, embezzlement, wrongful extraction, or willful application, or misappropriation, or breach of trust," there is little danger of loss through collusion between the operatives of the warehousing company and the agents of the borrower.

Overdrafts.—Overdrafts are sometimes tolerated by banks when checks are honored because the funds they withdraw are actually within the control of the bank though the bank

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to protect itself takes back from its customer, the importer, what is known as a trust receipt." W. Taylor, "Trust Receipts," *Cornell Law Quarterly*, January, 1921, pages 168–69. For a diagram of a similar transaction, see page 486. See "The Trust Receipt as Security," a pamphlet by Karl T. Frederick, published by the American Acceptance Council, and an article entitled "Concerning Trust Receipts," by the same author, in the *Acceptance Bulletin* of December, 1930.

[20] While the trust receipt was first introduced in the financing of imports, its use has spread to domestic trade. With its growth, cases have arisen dealing with the rights of the lender as against creditors of the borrower. Great lack of understanding of the trust receipt is disclosed in these cases. Up to 1929, a majority of the cases held the lender's interest valid as against the borrower's creditors, but invalid as against a bona fide purchaser (including mortgagee or pledgee) from the borrower. Since 1930, the decisions have tended to deny validity even as against creditors. This development has led to a movement for the adoption of a Uniform Trust Receipts Act by the various States. The Act, which had been adopted by nine States up to 1939, requires recording of the trust receipt and sets out the rights of the lender, borrower, and third parties. For a discussion of trust receipts, and the Uniform Act, see Prentice-Hall Installment and Conditional Sales Service.

may not yet have collected them. The practice, however, is altogether repugnant to good business.[21]

Commercial paper houses and note brokers.—Large companies whose needs for working funds are very extensive often borrow from banks in all parts of the country through the medium of commercial paper houses. These firms are sometimes called note brokers. The commercial paper house either acts as a broker between the company issuing the notes and the purchaser of the notes, or buys the paper from the issuing company and then sells it.

Shortly after the Civil War, the usual method of borrowing from banks other than those with which the company kept its own deposits was through the aid of the note broker. Gradually, there came into existence commercial paper houses which bought the paper outright instead of merely acting as broker. At first, the commercial paper houses met with opposition from the banks, who thought that their own functions were being preempted; in later years they grew rapidly and largely displaced the note brokers, though they did not supplant them entirely.[22]

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[21] "No one in the United States should overdraw his account In England a depositor arranges to overdraw up to a certain amount and pays interest upon his overdrafts as U S Americans do upon loans Scotch credits are arranged in a similar way A customer of the Banco de Chile may arrange an open account for as much as he is responsible, say $20,000, for which he pays ½% commission every six months The customer can then check against his limit and pays 9% interest on whatever he draws In Germany before the Great War a customer could arrange a maximum limit of overdraft by checks. On his overdrafts he paid 1% above the Reichsbank rate plus a commission of ⅛% a month, while on his balances he received 1% to 2% under the Reichsbank rate. On the contrary in the United States an overdraft is a forced loan without interest and a bank officer has no right to permit it If he does, it is 'at his own peril and upon the responsibility of himself and sureties' An overdraft may occur by mistake It ought not to happen intentionally, when a person can go to his bank and arrange a demand loan for fifty cents or one dollar and upward." J. A Fitzgerald, "Making Use of a Bank," page 85

For form of note to cover overdrafts, see C. W Gerstenberg, "Materials of Corporation Finance," page 904

[22] The volume of business done by commercial paper houses reached its peak in January, 1920, when $1,296,000,000 of commercial paper was outstanding The volume declined steadily until, in May, 1933, it fell to 5 per cent of the 1920 high At the beginning of 1939 the volume was still under 20 per cent of the peak Several factors were responsible for the decline after 1920, the most important of which are the following (1) a decline in the need for working capital due to the changes indicated in footnote 9 on page 453; (2) the accumulation of surplus funds by corporations in the post-war period; (3) the increase in long-term financing by corporations which took advantage of the favorable

Operation of commercial paper houses.—Those who borrow from a commercial paper house are large nationally known industrial and mercantile concerns with capital of not less than a quarter of a million dollars The borrower issues notes in denominations that range from $5,000 to $100,000. The notes generally run approximately six months and are not renewable. The borrowing company, instead of renewing its notes, may replace them with new issues No interest is paid on these notes, as a rule, but they are sold to the commercial paper houses at their face value less a discount. The discount rate depends upon the locality, the market conditions, and the character of the paper. The commercial paper house also charges a commission of from ¼ to ½ per cent, regardless of when the paper matures. It makes a profit in addition to the commission by selling the paper to purchasers, who are for the most part banks,[23] at a lower rate of discount than that at which it purchased the paper. The paper dealt in by these houses generally consists of unsecured promissory notes, signed only by the issuing corporation, though other classes of paper, especially acceptances, may be included in the portfolios of the commercial paper house. If the house does not buy the paper outright, but acts as did the old time note broker, merely bringing sellers and purchasers together, the payment to the commercial paper house is a commission only.[24]

Commercial paper sold in this way is used for seasonal and emergency circulating capital, and for periodically furnishing funds to close out loans at a company's own bank or banks.

Advantages of using commercial paper houses.—(1) The chief advantage of the system of obtaining working capital in the open market, that is, of selling paper to commercial paper houses, arises from the fact that the examination of

security markets, especially after 1927; (4) competition by banks which were willing to give preferential rates to companies strong enough to sell their paper to commercial paper houses

[23] Commercial paper is considered a prime short-term investment. Banks find it an ideal investment; the losses suffered by banks through the purchase of such paper have been negligible

[24] Commercial paper sales of the entire country in 1938 were handled by about thirteen houses, most of which could trace their origin to the 1870's. The leading commercial paper houses include Goldman, Sachs & Co.; F. S. Moseley & Co , Conrade, Bruce & Co ; Lahey, Fargo & Co ; Piper, Jaffray & Hopwood; and A. G. Becker & Co. See A. O. Greef, "The Commercial Paper House in the United States."

the borrower's credit standing is centralized in the broker, whose relationships with the borrower are so extensive that he can afford to keep himself well informed, and so extensive with the banks that he must perforce not make any mistake in offering paper that "goes bad." (2) The wide distribution of the loans enables the concern to get the advantage of lower rates in those parts of the country where borrowing pressure is low. (3) Borrowing from commercial paper houses permits the company to expand in a way that might be impossible if the firm depended upon local banks (4) Broad distribution of paper has advertising value and establishes credit standing of the highest character. (5) The national recognition may be of value at some future time when the company undertakes to sell its securities to the public. (6) The borrower obtains the experience and advice of the commercial paper house with which it deals, and sometimes assistance in arranging new banking connections. (7) The entire proceeds of the loan are turned over to the borrower and he is not compelled, as he is when he borrows from a bank, to leave on deposit a balance of 20 per cent of the loan.

Disadvantages of borrowing from commercial paper houses.—(1) One disadvantage to the company borrowing from commercial paper houses is that the thorough examination made by the latter subjects the company to numerous inquiries and requires it to render reports and disclose information that it may be unwilling to divulge. (2) The claim has been made that the cost of financing is higher, in the long run, if the open market is used than if the company depends upon a bank alone. If the paper cannot be bought and disposed of at a profit in the open market, the commercial paper house will not buy it and the company must return to its bank for credit; as a result it will probably be required to pay more than it would have had to pay if it had dealt with the bank in the first place (3) While the company receives the entire proceeds of its note issue, and is not required as in the case of a bank loan to maintain at the bank a deposit of 20 per cent of the loan, the company must nevertheless have a good bank balance or its paper will not be purchased.

Acceptance dealers.—Similar to the commercial paper houses in method of operation are the acceptance dealers.[25]

[25] "Discount Corporation of New York discounts approved bankers' acceptances and trade acceptances with bank endorsements. It buys and sells all

These firms usually restrict their purchases to trade acceptances and bankers' acceptances, that is, to paper which originates in actual specific commercial transactions and which is therefore self-liquidating. They purchase largely from traders, banks, and from shippers of merchandise who receive acceptances in payment; they sell to commercial banks, trust companies, savings banks, corporations, trustees who have idle funds for temporary investment, and individuals.

The buying and selling engaged in by the commercial paper houses and the discount houses, as well as by the Federal Reserve banks,[26] make up what is known as the open market The business of the open market has grown considerably since the war and is beginning to resemble very closely the British Commercial Money Market.[27]

How commercial paper houses and acceptance dealers are financed.—These companies get a large part of their capital from original investment in their stock; to some extent they issue debt obligations—bonds; much of their purchases is resold; some of their purchases of commercial paper and trade and bankers' acceptances are pledged with the banks as securities for loans; to some extent these companies borrow from the banks on their own notes.

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short term government obligations It receives funds repayable on demand or at fixed maturity against the security of bankers' acceptances or government obligations It acts as sort of "back log" in the bill market, tending to absorb an oversupply, or to feed out bills to the market when it displays a readiness to take them In this way it exercises a very stabilizing effect upon the market, and performs a service similar to that of the great discount houses of London, which long ago contributed to establish that as the world center for liquid banking funds" From *Wall Street Journal*, February 8, 1924

[26] The operations of the Federal Reserve banks in the open market are governed by the Federal Open Market Committee, which was organized after the enactment of the Banking Act of 1933, and reorganized in 1935

[27] See J A Fitzgerald, "Making Use of a Bank," for a brief description of the American open market For a very concise and excellent description of the English market, see an article by H A E. Chandler, economist for the National Bank of Commerce in New York, in that bank's *Commerce Monthly*, February, 1924.

Chapter XXV

WORKING CAPITAL (Concluded)

Commercial credit houses.—Often the work of the commercial credit houses and that of the finance companies is combined in one concern, but we shall describe separately the function of discounting receivables as appropriately belonging to the commercial credit houses, and that of financing the sale of specific commodities, such as automobiles, pianos, and the like, as belonging to finance companies.[1]

The work of the commercial credit houses is to purchase or discount receivables,[2] either open accounts, notes, or acceptances, of customers of the merchants with whom they do business, to advance part of the face value (usually from 75 per cent to 80 per cent, though in some cases the margin runs from about 65 to 85 per cent), and to reimburse themselves out of the accounts or other receivables as they are collected, finally turning back to the seller any amounts collected or any accounts uncollected after the commercial credit company's advance and charges have been met.

Whose accounts are purchased.—The companies that sell their receivables to the commercial credit houses are usually relatively small—the majority have a net worth of less than $100,000. One of the largest commercial credit houses classifies the firms selling accounts as follows:[3]

[1] The work of these combined companies was classified by the Division of Analysis and Research of the Federal Reserve Board (Final Bulletin, January, 1923) as follows (1) Discounting or buying commercial receivables—that is, accounts, notes, or acceptances; (2) advancing to dealers funds with which to purchase automobiles (wholesale sale of automobiles); (3) advancing funds to enable dealers to sell automobiles on the installment plan (retail sale of automobiles), (4) advancing funds to enable dealers to sell furniture, agricultural implements, books, musical instruments, refrigerators, restaurant fixtures, household utensils, electrical appliances, etc , on the installment plan; (5) advancing funds against merchandise

[2] Where the commercial credit house is organized under the banking laws of the State wherein it does business, it may loan on the security of receivables; if it is organized as an ordinary business corporation, it may not make loans, and therefore it purchases the receivables

[3] A E Duncan, "The Assignment of Open Accounts Receivable," *Coast Banker*, May, 1922.

1. Live-wire money-making concerns, whose energy, ability, and plant capacity are out of proportion to their invested capital—no matter how large they are. The total cost is quickly covered by the added profit on increased sales.

2 Many such concerns regard a credit company as a "silent partner" with elastic resources, and prefer to divide a small part of their profits with such company temporarily and continue in control of their business instead of paying a large portion thereof permanently to new partners or stockholders, involving extra salaries, possible loss of control, etc.

3. Many firms are more experienced in the practical manufacturing and selling part of their business than in finance, and dislike to borrow much money from banks, with which they will not carry substantial balances.

4. Many others, especially manufacturers, have most of their invested capital tied up in real estate, plant, machinery, etc , usually blue-penciled by the banker. Their current assets are out of proportion to current liabilities, although they may sell to the very highest rated trade.

5 Many firms are located in towns having limited local banking facilities, and have not established, or for many reasons may be unable to establish, sufficient bank credit connections in the larger cities.

6. Many others need "extra" money just to carry them through the peak of their season or to buy for spot cash, discount or pay their bills promptly or increase their volume, with but little increase of overhead. The saving in discounts alone will probably offset the cost.

7. Many firms must sell on from six to twelve months' time, payable in installments, and thereby quickly tie up their operating capital, and must find a continuous outlet for such paper

Though the same concerns generally remain clients of the commercial credit house, there seems to be a tendency among such clients to outgrow the need for assistance. Usually the commercial credit house is used in addition to a local bank, the former frequently being used to close out the line of bank credit for a period of from 30 to 60 days once a year.

Commercial credit houses do not ordinarily accept assignments from houses whose ratings with Dun & Bradstreet, Inc. are lower than second class. The statement made by one house that it excludes "lines highly specialized; lines lacking intrinsic value, lines not readily resalable; lines whose value depends on continuity of customers in business," furnishes a standard at which, probably, most houses aim.

The amount of receivables that will be purchased is usually determined by a consideration of each situation as it arises when an application is made. Where regular dealings are maintained, however, some credit houses set a definite credit line and advise their customers thereof; in some cases a maximum figure is set and nothing is said to the customer about this maximum unless an application is made that would

exceed it; in other cases new accounts are constantly accepted until such time as the credit house believes its customer is unduly overexpanding. A balance of less than $10,000 is usually considered not worth-while; the average amount probably runs between $50,000 and $100,000, although in special cases the larger amount may be exceeded by a considerable margin.

In some cases the commercial credit house acts as general financial agent, undertaking to discount all accounts. One contract that we have examined goes even so far as to commit the credit house to the obligation of acting as a *del credere* agent, that is, a guarantor of the accounts. In such cases, of course, the credit house checks the credit before the order for goods is accepted, moreover, its charges for this service are to be included in the cost of discounting, as is also compensation for the risk run in guaranteeing the account

The following is a form of agreement for discounting all the accounts receivable of a client.

MEMORANDUM OF AGREEMENT BETWEEN H ELMAN BROS., BANKERS, AND JOHN SMITH, HEREINAFTER CALLED "THE CLIENT," MADE THIS —— DAY OF ————, 19—.

H. Elman Bros. agree:

To Investigate and furnish information bearing upon the financial responsibility of the customers of The Client.
To Supervise the collection of accounts of The Client and use their best endeavors to collect the accounts assigned to them.
To Issue statements for comparison as and when necessary
To Draw drafts upon delinquent debtors as and when necessary
To Render reports of collections
To Maintain for the exclusive use of The Client a separate ledger account of accounts submitted.

In Consideration of the aforesaid services The Client agrees:

To Submit to H. Elman Bros all of the outstanding accounts and to pay H. Elman Bros. *One and one-half* (1½%) *per centum* commission on the amount of such accounts.

H. Elman Bros. agree:

To Advance to The Client *Seventy* (70%) *per centum* of the net face value of such accounts as may be acceptable to them for that purpose.

In Consideration of the aforesaid advances The Client agrees:

To Pay H. Elman Bros. interest at the rate of six (6%) per centum per annum from the time of advancement to the time of payment, plus ten (10) days' interest in lieu of exchange on out-of-town checks.

To Assign and transfer to H ELMAN BROS. all outstanding accounts as the same are created in THE CLIENT's business, from and by the sales of merchandise therein, and not to apply for or procure advances on accounts from any source other than H. ELMAN BROS during the continuance of this agreement, the said assignment shall be in the form prescribed by H. ELMAN BROS., accompanied by shipping receipts and such other papers as H. ELMAN BROS may prescribe

That H ELMAN BROS or their representative shall have the right to examine all the books of THE CLIENT (which may appertain to the accounts) and to endorse the name of THE CLIENT on any and all commercial paper received in payment of said accounts wherever such endorsement is necessary to vest title to said commercial paper in H. ELMAN BROS, authorizing and empowering H ELMAN BROS to sue for and collect said accounts in their name or in the name of THE CLIENT, and to take such steps as H. ELMAN BROS may deem necessary for the protection of their rights in the account, all legal and other expenses incurred by said H. ELMAN BROS. in collecting said accounts and in collecting their loans made to THE CLIENT hereunder, shall be paid by THE CLIENT to H ELMAN BROS.

To Keep on reserve with H. ELMAN BROS. *Thirty (30%) per centum* of the accounts outstanding (but not less than the amount owing by any single account) which reserve shall be subject to any and all claims, allowances, returned goods, accounts in default or bankruptcy, or other charges or deductions from any of the accounts, and as further collateral security for the performance of the terms of this or any other agreement between H ELMAN BROS and THE CLIENT.

To Send H ELMAN BROS. between the first and tenth of each month a statement of the preceding month's transactions, if so requested.

To Pay H. ELMAN BROS. in cash or allow them to deduct without regard to the maturity of the account, the amount of any merchandise returned, refused or rejected

That H ELMAN BROS. shall have a lien on all moneys, property or collateral of THE CLIENT now or hereafter in their hands or under their control for any and all indebtedness which may exist in their favor under this agreement, and also for any other indebtedness now existing or that may hereafter be contracted under this agreement or otherwise, *due or to become due.*

The term of this agreement shall be from the . day of . , 19 , to the day of , 19 ; thereafter this agreement shall continue from year to year unless ninety (90) days prior to the expiration of any given year, notice in writing of election to discontinue shall be given by either party to the other, by registered mail After notice of discontinuance has been given by either party to the other, THE CLIENT will keep on reserve with H. ELMAN BROS. thirty-three and one-third (33 ⅓) per centum of the accounts outstanding until all outstanding accounts are paid. Any notices or communications to be given hereunder may be given by mail, addressed to the business address of the parties hereto. It is agreed that this contract shall be construed according to and governed by the laws of the State of New York.

This agreement shall be terminable at any time, without notice, at the option of H. ELMAN BROS., upon the violation of any of its terms by THE CLIENT.

Witnessed by	(Signed) H ELMAN BROS
(Signed) A. B. DOWNS.	(Signed) JOHN SMITH

Notification and non-notification plans.—Accounts are bought on either the notification or non-notification plan. If the notification plan is used, the debtors of the merchant are notified that their accounts have been assigned and that they are to pay directly to the commercial credit house The purpose is to protect the credit house from collection and fraudulent appropriation by the merchant. Most frequently, however, the debtor is not notified, the account is collected by the original creditor, that is, the merchant, and the proceeds are turned over to the credit house. The objection to the notification plan is that the merchant's debtor dislikes being told that he is to pay his account to a third person; he suspects that the merchant to whom he owes the money is financially weak and unreliable, and realizes that if his account is not paid promptly, a third person, the commercial credit house, will know about his delinquency and thus his credit standing will be jeopardized.

Effect of assignment of accounts on creditors of seller—what constitutes fraud.—It may pay to discuss the question of disclosure a bit further, for it raises one of the questions about which there has been much discussion. Let us assume that *A* assigns the accounts of *X* and *Y*, due *A*, to *M*, a commercial credit house. What is the effect on *R*, a mercantile creditor of *A*? Let us suppose that subsequent to the assignment, *R* sold additional goods to *A* on credit. Does the fact that *A* or *M* did not notify *R* constitute a fraud against *A*? Probably not. Fraud would arise only if *R* were given some financial statement, on which he relied, showing that the receivables that had been assigned still belonged to *A*.[4] Of course if the notification plan were used, though the notice would be given to *A*'s debtors and not to *R*, the latter would likely discover through trade gossip the fact that the accounts had been assigned, and would be more reluctant to sell to

[4] Assigning the same account to two different credit houses, or collecting money and appropriating it instead of turning it over to the credit house, constitutes larceny. For a record of a conviction, see *The Credit Monthly*, February, 1924, page 36.

A on credit. The chief objection made by mercantile creditors is that the accounts or notes or acceptances which *M* would purchase, would be those due from *A*'s most reliable customers. Thus, in case of *A*'s failure, his general creditors would find that the assets on which they had placed their chief reliance had been withdrawn.

A further objection is made by general mercantile creditors that when accounts are assigned, the cash that takes their place is much less than the amount of assets assigned. The decrease, of course, constitutes the charges of the credit house.

Charges for discounting.—The charges made by commercial credit companies vary, not only from company to company, but from customer to customer of the same commercial credit house. The usual charge, however, is "one-twenty-fifth of one per cent a day on the net face amount of receivables, plus a charge of $5 per $1,000 on the first $100,000 of receivables within any twelve successive months." These charges include interest and payment for services. Thus, if at different times in a year sums to the amount of $1,000,000 were advanced to a business, each amount being loaned for fifty days, the flat charge of $5 per $1,000 for the first $100,000 would amount to $500, and the interest of 1/25 of 1 per cent a day for fifty days would amount to 2 per cent, or $20,000, the entire cost being $20,500.[5]

Where a definite sum of money is advanced by a credit house on the security of assigned accounts, the contract entered into between the credit house and the merchant will include the following provisions:[6]

1. The actual assignment of the accounts, which is supplemented by a schedule of invoices.

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[5] The commercial credit houses point out that this cost may be compared with terms of 3/10 net 60 Thus, if a seller, instead of selling his account to a commercial credit house, gave one of its customers who bought goods on sixty days credit a 3 per cent discount for paying within ten days of the date of the invoice, the cost would be $30,000. The comparison is not altogether fair. If the cash discount is taken, the seller is sure of his money. If the discount is not taken and the account is sold, the merchant must guarantee the account to the credit house A number of contingencies may arise to prevent payment of the $1,000,000 or even of the $820,500 (assuming 80 per cent, or $800,000, was advanced and the charges were, as we saw above, $20,500); the debtor may fail, or he may claim shortage in delivery, or damage, or failure of the goods to come up to specification

[6] The contracts vary somewhat from house to house; for another form, see C. W. Gerstenberg, "Materials of Corporation Finance," pages 908–9.

2. A statement of the charges and the time when payments are to be made by the assignor.

3. A statement constituting the assignee attorney to transact any business relating to the receivables assigned, including the power to indorse checks, drafts, notes, and other documents received in payment of the assigned accounts.

4. Where the non-notification plan is used, an agreement that the merchant will send to the commercial credit house immediately, in the form in which they are received, all payments made on the assigned accounts.

Usually, the assignor also guarantees that the debtors are solvent and that they will remain so till the accounts mature; that all payments will be made in full in cash to the assignee, that the accounts were owing, not for consignments, but for *bona fide* sales on which deliveries have been made; that there are no offsets or counterclaims to the accounts, that the accounts have not been assigned to any other person; and that no other accounts will be sold to other persons without giving the credit house a specified number of days' notice.[7]

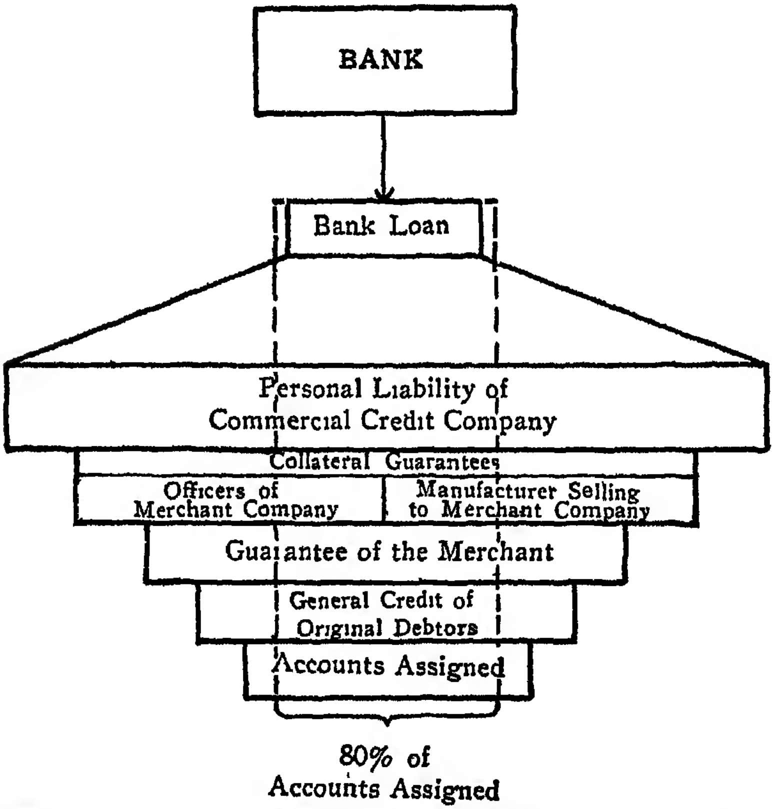
Most accounts that are accepted have a maturity of from forty-five to sixty days, though sometimes the term of credit may be ninety days or even, in exceptional cases, six months Notes and acceptances are usually held by the credit house till maturity and then collected by it, though sometimes the merchant is permitted to collect.

Where the non-notification plan is used, the assignee usually sends its own auditors to inspect the books of the merchant to see that none of the assigned accounts has been collected, except those on which the merchant has remitted the proceeds to the credit house. The merchant may be periodically requested to sign a list of unpaid assigned accounts. A further check is sometimes made by corresponding with some of the debtors to ascertain whether they have made payment. Since in the notification plan the accounts are paid directly to the credit house, this system of auditing and checking is unnecessary.

Losses of commercial credit houses.—The credit house has as security for its advances and charges, first, the debt owing from the customer of the merchant; second, the general liability of the merchant; and third, in some cases, a personal

[7] If *A* assigned certain accounts to *M* and then assigned the same account to *N*, *M* would be the owner, even though *N* were an innocent purchaser.

guarantee from the officers of the merchant company or from some other person—as, for example, some manufacturer who does a large business with the merchant. If accounts are not paid promptly, they are usually carried from thirty to sixty days at the stipulated cost and are then resold to the merchant, who pays for them either in cash or with other good accounts receivable Out-and-out loss arises only where there is fraud or where both the merchant and his debtor fail. One credit house reported its losses over a period of about ten years to be annually 0.0012 per cent



METHOD OF FINANCING COMMERCIAL CREDIT COMPANY THROUGH DEPOSITING ASSIGNED ACCOUNTS WITH A BANK AS SECURITY FOR A BANK LOAN

While the credit company advances 80 per cent of the amount of the accounts assigned by its client, the bank will lend the credit company on the security of the assigned accounts a similar sum The diagram shows the various elements of the security which the bank has for its loan

Financing credit houses.—Companies of this kind are usually started with an investment from stockholders in common and preferred stock. Such companies raise funds also by depositing their purchased receivables with a trustee as security for notes, usually of $500 denominations, most of which are sold to banks.[8] These notes may mature in from thirty days to twelve months, though the average term is six months. Some funds are obtained from the bank of deposit of the credit house, with or without collateral, and sometimes unsecured notes are sold through commercial paper houses in much the same way as any mercantile house would handle them. Sometimes short term notes running for several years are sold to the general public.

Profits of credit houses.—A study made by the Federal Reserve Board[9] states that most frequently turnover of capital investment of these companies is from eight to twelve times, though it may range from five to twenty times. The largest company in the country, which, however, does work that we have designated as that of a finance company, claims to have made only 14 per cent on all cash paid in. Some companies probably earn as high as 30 per cent on actual cash paid in.

Finance companies.—Finance companies, as they are treated here, include all corporations that assist in financing the sale of definite merchandise, including chiefly automobiles, radios, pianos, electrical household equipment, and similar goods.[10] Their work is divided into two parts, that dealing with financing the wholesaler, and that dealing with the sale of goods to consumers by retailers. Under the wholesale plan, the finance companies finance sales to distributors, dealers, and subdealers, advancing from 60 to 90 per cent of

[8] The fact that banks usually get a nominal rate of 6 per cent with an actual rate of 7½ to 8 per cent on loans made to commercial credit companies has helped to dispel a certain aloofness that existed when the credit companies first came into existence. (Notice, however, that the assignment of an account receivable is not rediscountable with the Federal Reserve banks *Federal Reserve Bulletin*, May, 1916, page 227.) The loans are usually very secure, for they originate in commercial transactions and are secured by the personal obligation of the original debtor, of the merchant to whom the account is owed, and of the commercial credit house. Usually, the amount which a credit company is permitted by the trust agreement to borrow is not in excess of five times the capital and surplus. See diagram on page 504

[9] *Federal Reserve Bulletin* (Final Edition), January, 1923

[10] One company has announced that it finances the sale of more than fifty different types of commodities.

the invoice price, the larger amount ordinarily only in cases where goods are stored in a public bonded warehouse. In some instances the only security the finance company will have is the obligation of the dealer or distributor to the manufacturer, plus a lien on the property represented by a warehouse receipt, a chattel mortgage, a trust receipt, or a conditional bill of sale (depending somewhat on the State laws). In other cases the manufacturer is asked to indorse the dealer's notes In the case of automobiles, a clause is usually inserted in the contract whereby the dealer agrees not to use the cars. In a few instances the finance company buys the cars from the manufacturer, and the dealer merely has an option to purchase.

Under the wholesale plan followed by one large automobile finance company, the dealer is granted a fixed line of credit. He deposits a certain sum (say from 10 to 20 per cent of the wholesale price of the cars shipped to him) to the credit of the finance company; the latter makes payment of the invoice price either by direct payment to the manufacturer or by paying the manufacturer's sight draft, at the same time taking title to the cars either by direct bill of sale from the manufacturer or by receiving the order bill of lading annexed to the sight draft and then delivering to the dealer under a trust receipt, the cars or the bill of lading representing the same. The dealer accepts a draft, running usually for three months, and is charged an amount sufficient to cover interest, service, and insurance. When a sale is made by the dealer, the car is released from trust and the charges are adjusted so that the dealer pays for the accommodation for only so long as the car has actually been used.

Financing retail sales.—In the financing of retail sales, title is usually vested in the finance company or a lien is given to the finance company through a conditional sale, chattel mortgage, or lease agreement. Where an automobile purchase is being financed, the buyer gives his note or notes to the seller, who indorses them to the finance company. Thus the latter will have as security the general credit of the consumer, the specific lien on the car, and the general credit of the dealer, though several large companies accept the notes of the purchaser without the indorsement of the dealer. The chattel mortgage, conditional sale, or lease agreement usually contains clauses that amply protect the finance company

against misuse of the automobile, and in addition the finance company usually requires the protection that can be afforded it through fire, theft, and property insurance. Generally, the finance company will itself check the credit of the purchaser, though frequently it relies upon investigations made by the dealer and on answers to questions submitted to the purchaser, which questions and answers are written on forms supplied by the finance company.

Charges of finance companies.—The charge made by finance companies for investigations, interest, service, and collection, approximates 15 per cent of the funds outstanding. Ordinarily, the purchaser of an automobile or other commodity is required to pay down from 10 to 33⅓ per cent[10a] and his notes are taken for the remainder of the purchase price plus the charge of the finance company. Since the notes usually mature serially, the actual rate of interest on the amount owed by the purchaser may run as high as 25 or 30 per cent. Charges are not uniformly made, however, since in some cases the rate paid includes a flat charge plus a discount on the amount of money advanced. Sometimes the flat charge includes the premium for insurance on the automobile or other property, which insurance is taken out in favor of the finance company. In other cases the insurance premium is quoted separately. In almost all instances the finance company is paid a commission on the insurance premium[11]

Financing finance companies.—The finance companies obtain their funds in the same way as has been described for commercial credit houses. In a number of instances the finance company is operated as a subsidiary of the manufacturing company whose products it finances. The General Motors Acceptance Corporation[12] is an example of a sub-

[10a] The policy of Government agencies such as the Electric Home & Farm Authority and the Federal Housing Administration, of advertising small down payments and long periods in which to pay, was reflected in the installment sales field by a tendency toward reduced down payments and longer periods of payment A reversal in the movement began in 1937, largely under the influence of the banks from which finance companies borrow

[11] In many cases, the finance company conducts an insurance business through a subsidiary.

[12] In 1929 several of the automobile manufacturing concerns disposed of their subsidiary finance companies The financing of sales by such concerns is now done by independently organized companies which do business with a number of manufacturers under separate contracts The two principal finance companies are Commercial Credit Company and The Commercial Investment Trust.

sidiary finance company. Such subsidiaries may receive advances from the manufacturing concerns with which they are allied.

Losses of finance companies.—The losses sustained under the wholesale plan are negligible. A study made of companies using the retail plan showed that the percentage of past-due accounts ranged from a fraction of 1 per cent up to 20 per cent. In 1936, 2.2 per cent of new cars financed by sales finance companies were repossessed, and 7.5 per cent of used cars were repossessed.[12a]

Working capital from affiliated companies.—While there is no elasticity in interest received on bonds—either those held for investment or those held for advances to subsidiaries—dividends on stocks of subsidiary companies do offer an expandable source of cash income. Sometimes an affiliated company can borrow cash more readily and on better terms than the principal concern. Inter-company accounts often provide flexible means of administering cash.

Loans from owners.—In unincorporated concerns, except the Massachusetts trust, ordinarily the only effect of advances from owners is to change the relationships between the owners themselves. Such loans do not rate as loans when the interests of outside creditors are at stake,[13] but merely take precedence over contributions of capital.

Sale of unnecessary assets.—The most accessible assets for sale, not used in the ordinary course of business, are securities held for investment, though sometimes physical property is available. A typical case is an unused factory building on which taxes and insurance are paid, as well as the wages of a watchman. Earlier sale may not have taken place because no offer for the building was forthcoming at anything like the original cost price. A sale "at the market" not only furnishes cash, but really eliminates some of the need for cash in that the carrying charges on the property are wiped out.

Conversion of fixed assets.—In periods of prolonged depression working capital is maintained by failure to replace to a normal extent the part of the fixed capital which is consumed in producing inventories.[13a]

[12a] See Milan V. Ayres, "The Economic Function of the Sales Finance Company," *Journal of American Statistical Association*, Mar., 1938.

[13] See discussion of partnerships, pages 52 *et seq.*

[13a] See Arthur H. Winakor, "Maintenance of Working Capital of Industrial Corporations by Conversion of Fixed Assets," Bulletin No. 49, University of Illinois.

Planning ahead—budgets.—Providing a business with cash when it needs it, without carrying over the interim periods an excess amount of current funds, is a problem that should be faced like any other problem in business—first from the angle of "planning" and then from the angle of "doing." The planning in this case calls for the construction of a budget.

A complete budget system requires the preparation of separate departmental schedules and the formation of a composite financial budget. First, the sales department must forecast its sales. From this forecast, the purchasing and the production departments can forecast the production costs and the purchase requirements, and the selling and shipping departments can estimate their expenses. Administration expenses can be more nearly approximated if the selling and production prospects are known. Finally, from the standpoint of expense, the demands for cash necessary to carry on each of the departments and to purchase new equipment, can be assembled in the expense schedules of the financial budget. Then, from the estimates of sales, the collection department can make its forecasts of cash income.[14]

The financial budget founded on cash receipts and disbursements is not sufficient; a budget should be made for every item in the balance sheet, so that the composite budget is really a forecast of the balance sheet at the end of the period for which the budget is made. In some organizations, in addition to the balance sheet budget, a cash receipts and disbursement budget is maintained.

In a concern of any size, some one officer ought to have charge of the budget. The responsibility of making the financial budget should not be left to the accounting department, though close co-operation with that department is essential in the preparation of any budget. In organizations too small to warrant a separate budget department, the manager, in preference to the accountant, can well perform the function of budget director.

The budget director ought to go over the departmental budgets, make the departmental compilers justify their

[14] See J O McKinsey, "Budget Making and Control"; Boston Chamber of Commerce, "Budgetary Control of Business"; and Bruère & Lazarus, "Applied Budgeting," for suggested forms

figures, suggest changes that might be expected from outside business conditions, and then consolidate the revised departmental budgets into the single financial budget. This budget[15] should be made up for only six months or a year in advance, and the officer in charge should check results very carefully each month, or even each week, and carry forward changes in future estimates that are suggested by current performances. For example, if sales are 10 per cent higher than have been estimated, the same percentage may be carried forward in the estimates of sales for future months. Most of the other figures will be correspondingly changed In order that the budget officer may know how to interpret and change his future estimates, each department should be called upon to submit revisions in writing on a form provided for that purpose and should be required to explain, period by period, why differences exist between the original estimates of performance and the actual records.

Financial reports concerning working capital.—The danger of embarrassment or even catastrophe from lack of working capital is so great that the executives of a business, large or small, must keep themselves well informed on its present and prospective cash positions. To do this, they will cause to be prepared various reports of receipts and disbursements and other important data. We shall describe briefly typical forms used for this purpose.

The form on page 511 is adapted from one in actual use and has the advantage of being available for daily, weekly, or other periodic reports.

While the form on page 512 is made up for two months only, in practice the columnar material would be repeated and it would provide a forecast of from three months to a year. In the first column are copied the figures for the corresponding month of the previous year, found in the third column. In the second column are the forecasts, and in the third column are inserted the actual results of the month's financial operations. In the fourth and fifth columns are inserted the percentages of differences between the figures in the third column and those, respectively, in the first and second, a plus

[15] The American Telephone & Telegraph Co has extended the use of its budget perhaps further than most other corporations. Through budget forecasts, it plans the extension of its business for from five to ten years ahead. One large gas and electric company budgets three years ahead.

sign (or black ink) being used where the actual figures are larger and a minus sign (or red ink) where they are smaller. As was indicated in the previous sections, this form can be

PRESENT CASH POSITION

Date, , 19

CASH RESOURCES			
Previous (day, week, or month) Cash Balance in Banks			
Bank A	$8,769 51		
Bank B	1,000 00		
Total		$9,769 51	
Cash in House		50 00	
Deposited			
Collections	1,571 39		
Loans and Discounts			
From Branches			
San Francisco	700 00		
Chicago	300 00		
Total Cash Deposited		2,571 39	
TOTAL CASH RESOURCES			$12,390 90
CASH DISBURSEMENTS.			
Weekly Payroll			
Semimonthly Salaries		3,591 50	
Salesmen's Commissions			
Accounts Payable		573 22	
Miscellaneous		93 14	
Interest			
Dividends			
Taxes		1,871 52	
Rent			
Insurance			
TOTAL DISBURSEMENTS			6,129 38
PRESENT CASH BALANCE			$6,261 52

filled out only after departmental budgets have been submitted showing sales and sales expenses, production and production expenses, purchases of materials and equipment, shipping expenses, and administrative expenses, and after the proper calculations have been made establishing the amount of collections to be expected in view of previous sales. An examination of the form will show that only the ordinarily

PROSPECTIVE CASH POSITION

CASH BUDGET , 19 , TO , 19

	January					February				
	Last Year	Estimate	Actual	Percentage Differences		Last Year	Estimate	Actual	Percentage Differences	
				Year	Estimate				Year	Estimate
RECEIPTS										
Collections	46,962	51,000	51,273	+ 9 18	+ 0 53	42,309	47,500			
Dividends and Interest	1,250	1,250	1,250							
Rents	250	250	250			250	250			
Other Income	73		17	−76 72	+17 00	20				
Total	48,535	52,500	52,790	+ 8 76	+ 0 55	42,579	47,750			
DISBURSEMENTS										
Weekly Pay Rolls	16,015	17,175	17,375	+ 8 49	+ 1 16	16,015	17,175			
Salaries (semimonthly)	8,765	9,242	9,242	+ 5 44		8,763	9,242			
Salesmen's Commissions	6,471	6,959	7,183	+11 00	+ 3 21	5,852	5,940			
Materials (usually listed in important classes)	8,219	9,187	9,073	+11 39	− 1 25	7,420	9,300			
Loans										
Taxes										
Insurance										
Rent	750	750	750			750	750			
Dividends	7,500	8,750	8,750	+16 66						
Other Items	615	712	893	+45 20	+25 42	475	650			
Total	48,335	52,775	53,266	+10 20	+ 0 93	39,275	43,057			
SURPLUS ACCUMULATED	6,728	5,748	5,547			10,032	10,441			
SOURCES OF NEW FUNDS										

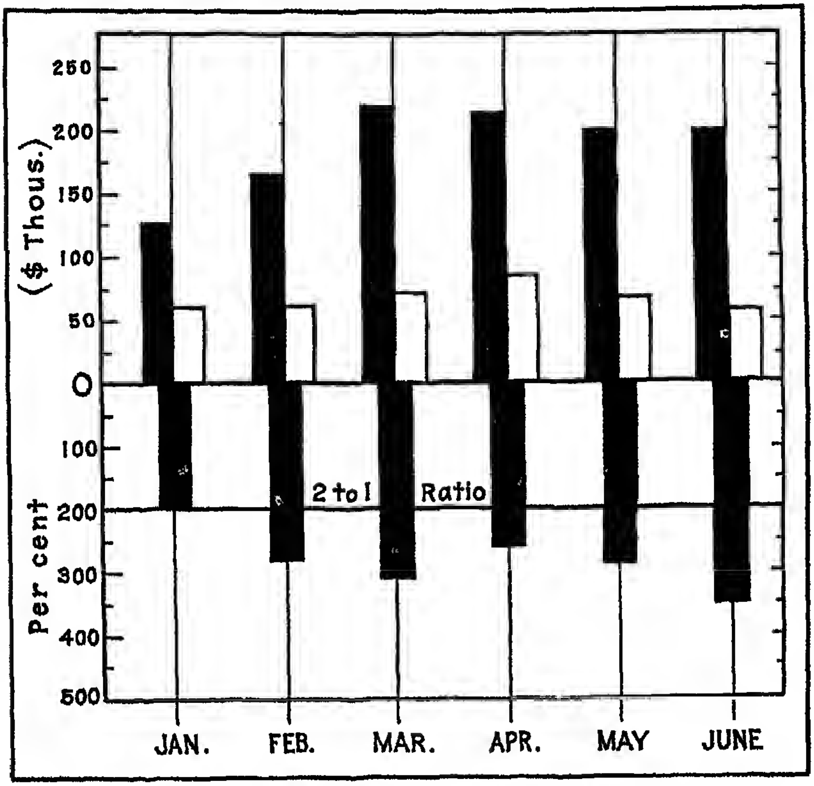
predictable and usual sources of receipts are listed in the upper part. If the disbursements are in excess of the receipts, the balance is taken from the item "surplus accumulated," which is merely the sum of the surpluses of the previous months and which indicates the cash on hand; if accumulated cash is not sufficient to meet the deficit, then the sources of new funds may be indicated as subheadings under the title "sources of new funds." Here the financial management will have to do its own planning; the possible sources of funds have been explained.

Graphical representation of important data concerning working capital.—To get the problem before the executive quickly is one of the aims of modern business management. If a vivid picture of the situation respecting working capital can be kept constantly before the management, it can readily discover and correct delinquencies. A little thought will help suggest forms in addition to those described below—forms which may be very helpful in keeping the executive "on his toes."

The current ratio.—The information needed is (1) the amount of circulating capital; (2) the amount of current payables; (3) the current ratio, found by dividing the current assets (circulating capital) by the current liabilities. The material needed is: paper ruled as described below, red and black gummed strips.

Paper is ruled with vertical lines to represent days, weeks, months, or years, for the same plan may be used no matter how frequently those using the chart desire to know the situation with respect to working capital. Three horizontal lines are drawn: the top line represents the maximum current assets the concern is likely to have; the second line is a zero line which divides the chart in half; the lowest line represents the maximum ratio of the current assets to the current liabilities. Above the zero line appears the amount of current assets (black strips) and the amount of current liabilities (red strips). The distance downward between the zero line and the lowest line shows the ratio of current assets to current liabilities. The ratio is represented as the percentage which the current assets bear to the current liabilities. A 500 per cent ratio, for example, indicates that there are $5 of current assets to every $1 of current liabilities, or a ratio of 5 to 1. A black strip is pasted downward from the zero

line to show the current ratio. Thus we readily get a picture of the ratio of current assets to current liabilities. A line representing the proper ratio for the company should be drawn in



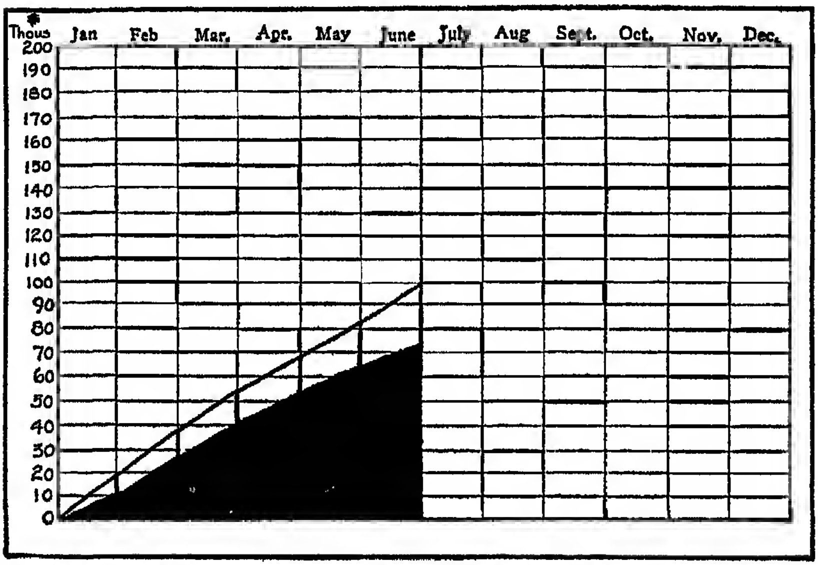
White strips are used instead of red recommended in the text

Graphic Representation of Current Ratio for the Executive

heavily so that the person reading the chart can see at a glance how the current position compares with the ideal ratio. A minimum ratio may be ruled in instead of an ideal ratio. In the illustration, it is assumed that 2 to 1 is the minimum ratio.

Sales, collections, and receivables.—In order to keep a careful chart of sales, it is advisable to use two kinds of paper, cross section paper and another paper of a different color, as well as the sort of frame used by photographers for printing pictures from negatives.

Plot each day, week, or month (depending on the need of the business) a curve showing sales and another showing collections as they accumulate from the beginning of the period for which the chart is made. At each vertical line connect the two curves; the distance thus marked off will be clearly recognized by the eye and will represent the outstanding receivables accumulated since the beginning of the period for which the chart is drawn Cut out with an ordinary scissors the part of the chart below the line of cash collections. Keep this chart in the photographer's frame, after you have placed it face down on the glass; the colored sheet will show through, clearly indicating the cash collections.

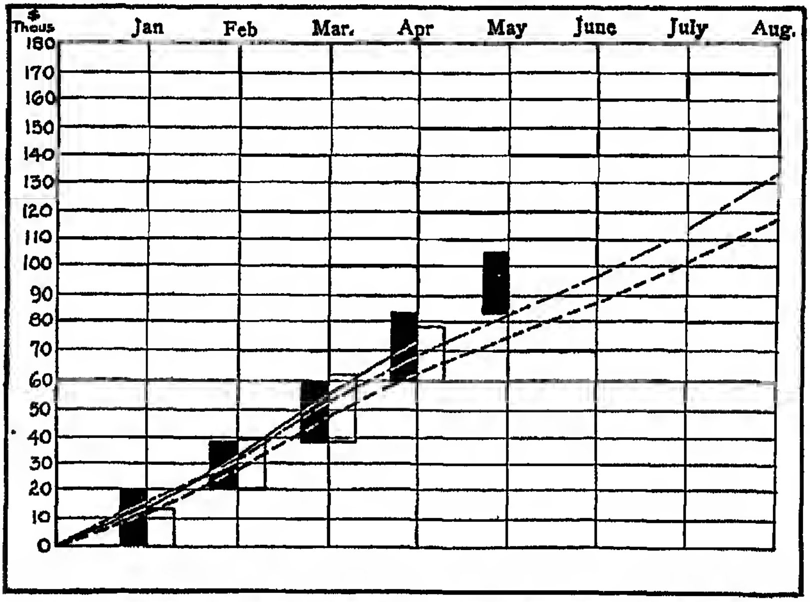


Graphic Representations to be Used By the Executive to Check Sales, Collections, and Accounts Receivable

Comparisons of sales and collections to show efficiency of collection department and to show efficiency of sales and collections compared with performances of the previous period.— Use cross section paper on which to draw curves showing (in black ink) the accumulated sales of the previous period (if a year's chart is being kept by weeks, the cross section paper will have to accommodate fifty-two items horizontally), and (in red ink) the accumulated collections of the previous period. Strips of red and black gummed paper should be

available, besides a bottle of green ink. The chart should be attached squarely to a drafting board, and a T square and right angle should also be at hand. We shall assume that the business is one in which goods are sold quite regularly through the year on uniform terms of thirty days' credit.

On the vertical line representing the first month (day, or week), lay down a black strip representing the amount of sales as shown by the scale at the margin of the chart. Do the same thing for each succeeding month, but lay the strip upwards from a point even with the top of the strip representing the previous month's sales. In this way we see clearly



Graphic Representations of Sales and Collections on a Comparative Basis

the amount of sales for each month (day, or week) and by letting the eye follow an imaginary line connecting the top of the strips, we see the accumulated sales for the year to date. Moreover, we get a comparison with the sales accumulated to the corresponding date of the previous year.

Since collections lag a month—the terms being thirty days—we lay down a red strip for the second month's collections alongside the black strip representing the first month's sales. If collections have been good, the two strips should be almost of equal length. If the red strip is much shorter, we

know something must be done to brace collections. In the same way the red strip representing the collections of the third month should be laid down beside the black strip representing the sales of the second month. A green curve may be used to accumulate the collections for the year, since the vertical red strips are not necessarily continuous as are the vertical black strips representing sales. The distance then between the red line and the green line (it would be well to lag both of these lines one month, that is, let the February collections be plotted on the vertical line that carries January sales) represents the difference between the collections of this year and last year. Moreover, the distance between the green line and the top of the black strips will represent approximately the accumulation of receivables for the current year.

Charting the budget.—The following description and charts are taken from "Budgeting for Business Control," a pamphlet published by the Fabricated Production Department of the Chamber of Commerce of the United States.

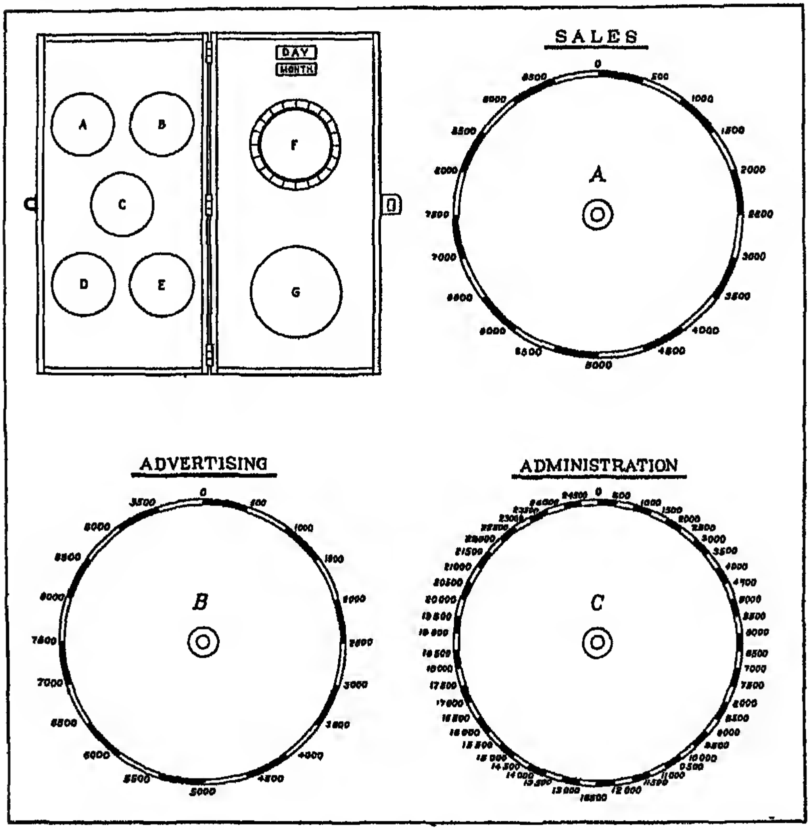
(Through the courtesy of the Shur-on Optical Company of Rochester their budget plan is herewith reproduced. It was devised for that company by Mr C. H Stephens, its secretary.)

Taking the personnel of our business into consideration, we decided to divide our activities into five groups. Material, Factory, Administration, Sales and Advertising On the 25th of each month the department heads submit their estimates for the following month. These are carefully gone over by the Comptroller, who is in charge of the Budget, the differences of opinion are taken up, increases and decreases are made and, on the first of the month, the established Budget is passed to each department head.

We have really put five men into a business of their own, telling them what the results of their next month's activities should be, together with the amount of money they may spend to produce these results. The Sales Manager is told how much in orders he is expected to get to keep the plant running; the Factory Superintendent, how much goods he must get out and how much accounts receivable he must create to provide the funds necessary in the following month; the Purchasing Agent, how much material is necessary to keep a well balanced inventory and take care of the plans of the Sales Department; the Advertising Department and Administration, how much money they may spend in carrying out these plans

We give our executives a daily picture of our individual departments and of the entire business. In the Comptroller's office we have a flat box, 2 inches deep, 24 inches wide, and 50 inches long, hanging on the wall. This is divided into two halves by hinges, with a latch and lock, which, when opened, shows a series of clocks, draftman's copies of which are given herewith, as well as a drawing of the box.

A, *B*, *C*, *D* and *E* are on the left. Each clock has two hands. The red hand is pointed at the budget allowance, remaining stationary for the entire month. The black one is daily set at the amount of money spent by each department to and including the date shown on the daily calendar which is at the middle top of the second section. There are circles *F* and *G* which are somewhat larger in diameter than the circles on the left. The current month is put under the calendar and this is the only change necessary in the



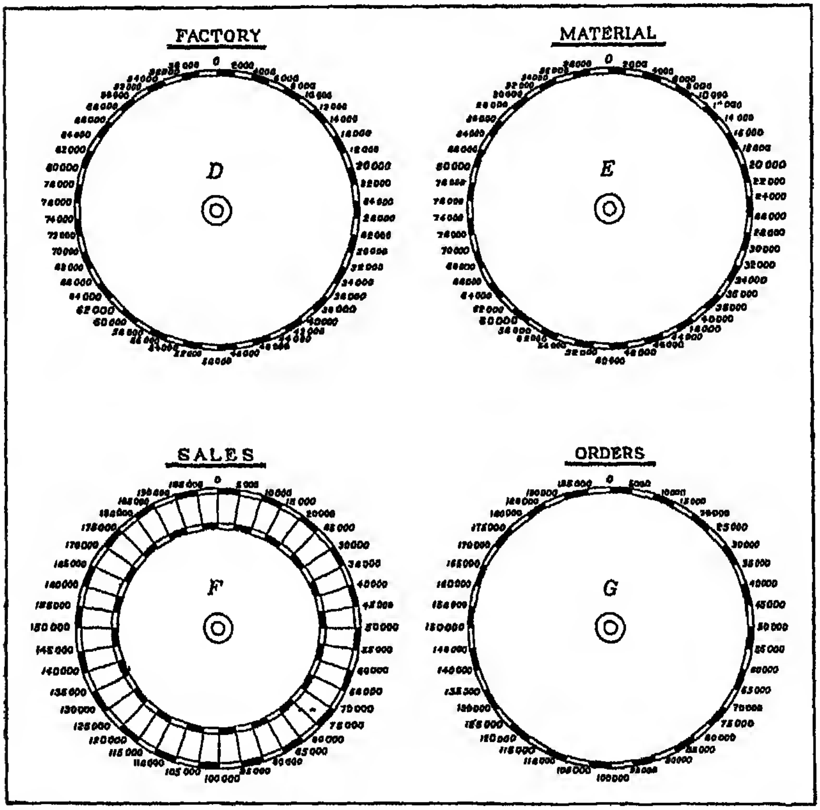
box monthly. Under this is *F* which has three hands, the first being a small black hand the point of which reaches to the inner circle only. This small black hand shows the total of the five black hands on the clocks *A*, *B*, *C*, *D* and *E* and indicates the total money spent by the whole business up to the date shown on the calendar. The last is a large red hand and shows the sales for the same month in the prior year as shown by the date of the calendar. To distinguish hands we have "1921" painted on the red one and "1922" on the black.

In addition, we have a pointer which points to the total sales of the corresponding month of the previous year. Circle *G*, orders, has only two hands. The black hand records the total orders received this month to date

and the red hand shows the same for the prior year. It also has a pointer which shows the total received for the same month of the prior year, similar to circle *F*.

Now then, what does one see when looking at this apparatus set for a day? Circles *A*, *B*, *C*, *D* and *E* show the total money budgeted for each department, by the red hand, and the total spent, by the black hand, they also show the remainder and the rate at which the department is going.

Circle *F* shows total sales for the corresponding month of the prior year



and the sales to date for the month, both current and prior years. It also shows the total money spent to date in the current month, current year

Circle *G* shows the total orders received in the corresponding month of the previous year and the orders received to date, both prior and current year, for the month.

[Orders, as referred to in circle *G*, mean all orders received from salesmen direct and through the mail. Sales, referred to in circle *F*, mean shipments of completed goods from our factory.—From a letter sent to the author by the company.]

A fairly complete picture—almost a daily profit and loss statement, excepting inventory changes only! This system has the big advantage of

showing a picture, in place of figures, of what each executive should know, and it is especially valuable where there are executives who will not and cannot read figures and monthly operating statements. It will warn you, much faster than your monthly operating statement, of danger ahead, irregularities in your business and violent fluctuations. It forces the Comptroller to stay right up to the minute.

We set these clocks once a day, about 10 30 A M., for the prior day. This helps in keeping everybody interested—on their toes! Wo give our Budget its share of the credit for having made a profit in 1921.[16]

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[16] See the chart of business activity on page 329 to understand why this record was an accomplishment.

Chapter XXVI

MANAGEMENT OF INCOME

Forms of income.—Ordinarily, three sources of regular income are available for large companies; and perhaps, too, these three sources are of the same relative importance for small companies. They are: (1) revenue from regular operations, (2) revenue from outside operations, and (3) income from investments. In reporting income, these three sources should be treated separately, in order that the managers may know just what the financial condition is.

We shall consider these three sources, beginning with the one which for an operating company is the least important, namely, income from investments.

Income from investments.—Investments are of two kinds: one kind holds funds temporarily, while the other represents control over subsidiaries and is therefore permanent.

Temporary investment of funds.—American companies generally do not seem to think it wise to accumulate funds for various contingencies, such as for dividend equalization, insurance, and the like.[1]

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[1] The growth in marketable securities appearing on the balance sheets of corporations from 1925 to 1929 showed that for a time the tendency was to accumulate funds The change was undoubtedly due to the new era in American business, following the post war period of readjustment Efficiency in production and distribution was greatly increased by the application of scientific methods of organization and control This development led to increased earnings and to an accumulation of available working capital in many instances beyond the needs of the business Higher earnings resulted in rising security prices; this tendency later developed into an inflationary movement The upward stock market trend over a period of four years (1925 to 1929) undoubtedly was the most important influence working toward expansion in the amounts of marketable securities owned by corporations Perhaps, too, there was a reluctance to turn profits over to owners in whose hands they would be subject to additional taxation. An examination of the balance sheets of several groups of industrial companies, presented in the "Census of American Corporations," a Works Progress Administration project sponsored by the Securities and Exchange Commission, revealed a decline in the value of marketable securities from 1934 to 1937

Against maintenance of funds to meet contingencies for which reserves are created, there is always the argument that funds invested directly in earning assets yield so much more than when invested in securities of other companies that the risk involved in the contingencies should be obviated, if possible, by very careful management instead of by tying up funds. This argument leads to the next, that if the business cannot profitably use accumulating funds, it should turn them over to the stockholders as dividends, so that each may invest the funds as he sees fit. At any rate, this practice prevents the manipulation that might arise if directors invested funds in various other corporate enterprises; it likewise keeps the attention of the officers on their own business problems and off investment problems.[2]

The vicissitudes of business have taught business men that if their companies are to stand firmly through a business depression and to maintain regular payments of dividends, they must conserve their earnings by creating ample reserves and by permitting the surplus to accumulate. Where such a conservative policy is adopted, the problem arises of investing the funds that represent savings for future contingencies.

The determination of an investment policy requires an understanding of sound investment principles and an analytical knowledge of the securities available for purchase. The principles of investment can be discussed but briefly here.[3] The corporation should look for securities which offer income combined with safety and which have a high degree of marketability. In general, it may be said that a company ought not to pay more for its funds than it can earn with them. Thus, if a fund is being accumulated to meet a maturing obligation, it should yield sufficient income to pay at least the interest on the obligation; else it would be wise to anticipate the maturity by negotiating for the investment of the fund in the obligation itself.

Diversification is one of the first principles of investment to be applied by the investors of the company's funds as a means of minimizing the investment risk. It should be made on the basis of types of securities, types of businesses and

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[2] See page 457

[3] See Ralph E Badger, "Investment Principles and Practices"; Chamberlain and Edwards, "The Principles of Bond Investment"; David F. Jordan, "Investments"; W. E. Lagerquist, "Investment Analysis."

industries, maturity dates, and houses of issue In applying these methods of diversification, the investor must be able to analyze the needs of his particular firm and the quality of the securities available.

In diversifying maturity dates of principal and income payments, the corporate investor will have in mind the cash requirements of the business. Thus, if funds will be needed at a certain time to redeem a certain amount of outstanding bonds, an investment in bonds that will permit the recovery of principal at or about that time would be advisable. When the principal payments are received, the corporation has immediate need for the funds and does not have to seek another investment for them.

The investor of the corporate funds may select securities that represent excellent diversification on the bases mentioned, but if he fills up his portfolio with securities that originate in a single investment house, he may defeat the purpose of his selection; for, if the originating house should get into financial difficulties, there is danger that many of the issues which it has sponsored will fall in value.

Diversification will be attained if those responsible for the investments arrive at an investment unit, that is, the amount which should be placed in any one security, and then apply that unit to all purchases. Thus, if the program which a corporation has for building up its investments in marketable securities calls for the creation of an ultimate fund of $3,500,000 through annual investments of a part of the earnings equal to $500,000, it may apply a 2 per cent investment unit and purchase not more than $10,000 of any one security.

Investments in subsidiary companies.—Income derived from the stocks and bonds of subsidiaries must be watched carefully. Whatever the income is, it must be examined at the source; the subsidiaries must be shown to be earning the income. Such questions as the following may be asked in respect to the subsidiaries: does the income flow from true earnings or does it arise from revaluations of assets or from sales of assets; before arriving at the amount of net income available for dividends, has the company made adequate allowance for the maintenance of its property; has the company followed those rules laid down in another chapter of this book, respecting dividend policies; is the company going

to need cash for meeting forthcoming maturities of funded indebtedness?[4]

Revenue from outside operations.—What constitutes outside operations depends very largely on the nature of the business. A railroad company may own oil properties, as did the Southern Pacific, or grain elevators, or a summer resort. In order that the railroad operations of a company may be compared with those of other railroads it is necessary that these outside sources of revenue be reported separately.[5]

However, a company like the American Can Company may start out with one line of business, and gradually take on side lines till the revenues[6] from those sources become as important as or more important than the revenue from the original product. Where it is possible—and there appears to be no good reason why it is not always possible—the accounts should be so kept that the company may ascertain the profits on its different lines and thus eliminate those that either do not pay or that divert too much attention from the profitable lines. It is surprising to one who examines actual cases, to observe how frequently sentiment, inertia, pride, and other purely personal elements are permitted to reduce the economic efficiency of business enterprises. The failure of H. B. Claflin Company in 1914 is a good example of the effect of pride in sustaining the existence of losing ventures. Had the management of this company given up the wholesale and jobbing business and gone into the retail chain store business exclusively, the name of Claflin might still be seen among the names of old successful houses.

In reporting income from outside sources, it is preferable to state the gross revenue, the operating costs, and, where pos-

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[4] In connection with income from investments, one should examine carefully the schedule of investments and make careful analysis of book values and present market values of the separate issues held These values should also be checked up with valuations determined by capitalizing the earnings of the subsidiaries

[5] Under the Commodities Clause of the amendment of 1906 to the Interstate Commerce Commission Act, railroads may not hold coal or oil properties In 1920, the Pacific Oil Co. was formed to take over the Southern Pacific's oil properties.

[6] The careful reader will have noticed the use of the words "revenue" and "income"—words that are popularly used synonymously. Technical usage sanctioned by the accounting rules of the Interstate Commerce Commission, reserves the word "revenue" to indicate those inflows of funds which are accompanied by regular outflows of funds, or costs, while "income" is used for an inflow without correlative outgo. Thus, we have revenue from operations and income from investments.

sible, even the fixed charges connected with the several operations, rather than to report simply the net income.[7]

Revenue from operations.—Three main topics and one subordinate topic must be considered in connection with operating revenue. These are. (1) size of revenue in relation to capital used, (2) steadiness of revenue, (3) increases in revenue in relation to operating expenses, and (4) relation of revenue to cash inflow and outflow.[8]

Size of revenue.—In studying the size of revenue, two questions must be considered: (1) the relation of the gross revenue to the amount of invested capital, and (2) the relation of gross revenue to the possible amount of revenue that a well-managed concern might obtain.

Relation of revenue to capital.—By studying the very best-managed concerns, we can ascertain what portion of revenues is likely to be consumed by operating expenses, and we can therefore tell about how much gross revenue should be obtained by a concern in order that, after the percentage for operating expenses is deducted, we may have a net revenue sufficient in size to pay a fair return on the amount of funds invested in the business.

In the electric light and power field, for example, it is felt that there should be $5 of investment for $1 of gross revenues; that is, annual gross revenues should be about one-fifth as large as the amount invested in plant and equipment.

Examples of relation of revenue to investment.—The ratio of operating expenses to operating revenues of a steam power plant is between 60 and 70 per cent. If a company has an operating ratio of 65 per cent, then sixty-five cents of every dollar of revenue goes to expenses, leaving thirty-five cents to compensate for invested capital. Thirty-five cents is 7 per cent of the $5 of investment required to earn the $1 of gross revenue. In the case of hydro-electrics, the operating ratio is not so high—say about 40 to 60 per cent. Therefore, from forty to sixty cents of every dollar of gross revenue is available as a return on investment. This forty to sixty

[7] Of course, where reports are to go to the general public, there may be an objection to giving the results of operations in such great detail that competitors are given an advantage We have in mind here generally, when speaking of reports, those furnished directors and officers to promote financial control, and in such reports, of course, enough information must be given to connect up given results with possible causes

[8] See the chapters on working capital for a discussion of the fourth topic.

cents is a fair return on an investment of from $6 to $8, and it is reasonable to say, therefore, that in the case of hydro-electrics, annual gross revenue should be from about one-sixth to one-eighth of the total investment.[9]

In mercantile and other corporations the relation of gross revenue to investment depends so much on the nature of the business that standard units for comparison cannot be given.

One of the simplest illustrations of this principle of the relation of gross revenue to total investment is the phrase contained in real estate advertisements found in metropolitan newspapers for indicating that the price of property is low "only four times the rents." Now the rents represent the gross revenue of a large apartment or tenement house, and the price is therefore considered low because it is only four times the gross revenue. We may give the following figures to show how such a relationship would work out:

Cost of property			$240,000
Rents		$60,000	
Taxes	$ 5,000		
Repairs	12,000		
Insurance	1,000		
Heat	2,000		
Water and light	1,500		
Janitor	1,500		
Vacancies	1,000	24,000	
Net Rent		$36,000	
Rate of Return			15%

In all cases, however, whatever may be the nature of the business, the ratio of gross revenue to total investment over a number of years should be examined carefully, and where possible, this ratio should be compared with the same ratio of other companies. As to the former comparison, merely a word of warning is necessary. In using figures for the total investment, care must be exercised to include only used and useful property and to see that proper deductions are made for depreciation. When these calculations are properly made, the results should be significant in showing (1) whether the company is carrying too great an amount of fixed assets, and (2) whether the company's gross revenues are large enough to support the plant. More exact information on

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[9] See *I. B. A. of A. Bulletin* (Investment Bankers Association of America), October 18, 1916

these questions will be obtained if the corresponding ratios for other companies can be used for making comparisons.[10]

Saturation of territory.—We turn now to the second part of the problem of the size of gross revenues: the relation of gross revenues to the possible amount of revenue that a well-managed concern might obtain. In considering the possible amount of revenues, we must draw attention to the principle known in the utilities field as "saturation of territory." By application of this principle it is possible to determine just what is the normal demand of the public for a given commodity or service and to ascertain (1) whether the demand is really there or whether it should be stimulated, and (2) whether the enterprise under consideration is supplying its share of the public demand. The former problem is one for a market analyst, and the latter has to do with the size of the competitive plants engaged in supplying a given demand. The methods used in solving the former problem were well illustrated under the subject of promotion.[11]

The price factor.—Gross revenue, however, depends not only on supply but also on the price at which the demand can be kept alive. The problem of fixing the price low enough to attract buyers but still high enough to yield the maximum aggregate return, is a question usually left to those in charge of the marketing function—the sales department. But the marketing department is interested primarily in "making a good showing" by increasing the total revenues, or "sales"; these aims of the sales department may defeat the

[10] Some attempt has been made at quantitative analysis of problems such as the one given above See, for example, J H Bliss, "Financial and Operating Ratios in Management", Wall & Duning, "Ratio Analysis of Financial Statements" Information as to typical ratios appears frequently in *Dun's Review*, published by Dun & Bradstreet, Inc See also the publications of the National Association of Cost Accountants, of the Controllers' Congress of the National Retail Dry Goods Association, and of the Bureaus of Business Research of Harvard, Illinois, New York, and Northwestern Universities Valuable information on ratios will also be found in the "Census of American Listed Corporations," a Works Progress Administration project, sponsored by the Securities and Exchange Commission Ratios for particular companies in the groups studied are presented for a series of years beginning with 1934, as well as other selected information

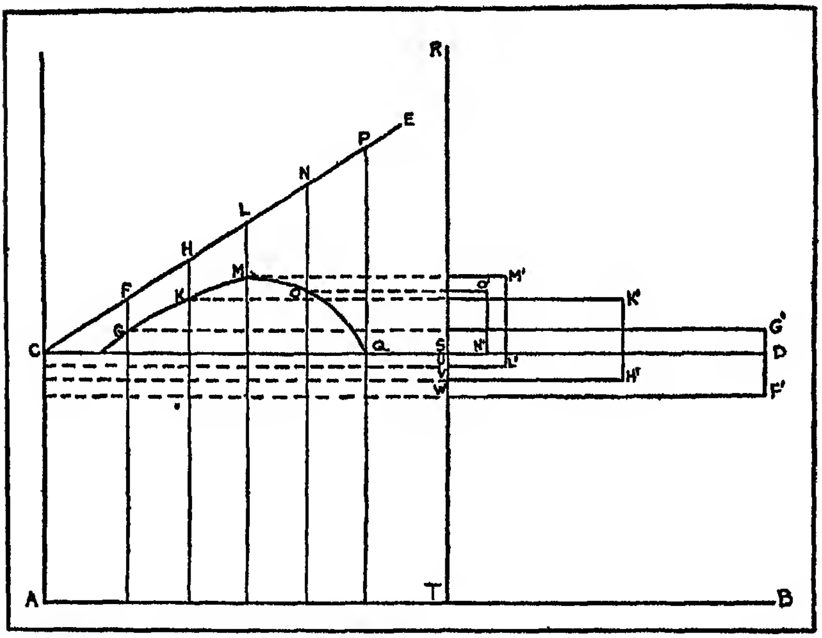
[11] See Chapter II See, in public utility field, F W Doolittle, "Studies in Cost, Urban Transportation Service," Chapter XX; G. P Watkins and L. H Lubarsky, "Consumption of Gas as Affected by Population," in *Journal of American Statistical Association*, Vol XV, page 405; Public Service Commission's Report, First Department, N Y., 1910. For industrials, see "Crain's Market Data Book and Directory."

purposes of the production department, which is concerned primarily with the diminution of the cost of production per unit of output. The marketing and the production departments therefore should be required to supply the financial or executive department with a schedule of estimated sales and costs, based on various scales of products that are likely to be produced and sold, and the ultimate decision of price should then be left to the financial or executive department, whose interest is not in how big the gross revenues shall be or how small the operating expenses per unit of output can be made, but in how these two problems can be reconciled to the company's ultimate advantage in the form of large profits.

The problem of the finance department in fixing price.—Since this problem of arbitrating between the marketing and the producing departments is one for the financial department to solve, we may analyze it somewhat more carefully; this analysis can best be carried out with the aid of a diagram, which, though it may seem somewhat complicated, will soon make the matter quite clear.

In the diagram on page 529, the distance between the two horizontal lines *AB* and *CD* represents the normal cost of producing a unit of output. (We mean by normal cost, for the sake of this argument, the cost of producing the unit under the average conditions to which the shop is accustomed.) *CE* represents the line of selling prices, and thus the distance between this oblique line and the horizontal line *CD* represents the margin for selling costs and profits. The next step is to mark off downwards to *G*, *K*, *M*, *O*, and *Q* from the oblique line at the top of the diagram the cost of selling per unit at the different prices indicated by the points *F*, *H*, *L*, *N*, and *P*. Thus, if the price is fixed at *F*, the cost of selling per unit will be *FG*; if fixed at *H*, the cost of selling will be *HK*; and so on. The distances between the horizontal line *CD*, and the irregular curved line *G*, *K*, *M*, *O*, and *Q*, therefore represent the profit per unit. It will be noted that as the price increases, the cost of selling increases until a point *P* is reached, where the cost of selling eats up all the profit. Now the tendency of the sales department is to increase prices and to pay higher commissions to a decreasing number of higher grade salesmen. To be sure, this tendency does not always prevail, and where it does not, the aims of the marketing and producing departments will not be in

conflict. But we are considering here the problem involved when this tendency of the sales department does exist. We must now direct our attention to the other part of the diagram. The line RT represents the base, from which we will mark off toward the right the number of units of products sold. Thus, if the price is fixed at N—a very high price—the number of units sold will be very small, as represented by the distance from RT to $O'N'$. Since, then, the distance from



Adapted from H L Gantt, "Industrial Leadership"

Relation of Price to Quantity of Production, and of Quantity of Production to Cost of Production, and the Relation of All Factors to Profits

O' to N' represents the profit per unit at this price, and the distance SN' represents the number of units sold, the rectangle SO' will represent the total profit of the business if the price is fixed at N. Suppose the price is fixed at L; we will sell more articles and consequently will be able to produce them at a slightly lower price, the reduction in cost being represented by the distance SU. In this case, then, the total profits will be UM'. Likewise, when the price is fixed at H, the profits will be VK'; and when it is fixed at F, they will be WG'.

The problem of the finance department is, then, to study the results of operations and sales in order to make the rectangles of profits as large as possible.[12]

Advantages of steady revenues.—We have been considering size of revenues; no less important is steadiness of revenues. It would seem that the advantages of a steady inflow of revenues are too obvious to need elucidation. Still, there may be some advantages which the business man will overlook.

1. In the first place, stability of gross revenues expands the amount of business that can safely be done on loaned capital. This point was explained in the chapter dealing with trading on the equity.[13]

2. Steady revenues permit the enterprise to maintain its organization. If it costs $500 to hire and train a salesman and $100 to hire and train laborers, one can see what a tremendous loss concerns incur, aside from loss of productivity, in discharging a thousand unnecessary employees.[14]

3. Steady business permits a concern to plan ahead carefully and to control its performance efficiently. Rush orders generally are not profitable.

4. Steady revenues make ultimately for steady dividends.

5. Steady revenues obviate some of the causes of manipulation, since they make fluctuations in stock values reflect unevenness in management.

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[12] The diagram and the accompanying argument, with a few changes and refinements, are taken from H L. Gantt, "Industrial Leadership," pages 111 *et seq* See Walter Rautenstrauch, "The Successful Control of Profits," pages 128 *et seq*, for a discussion of the determination of the increase in sales required to balance the effect of a given reduction in selling price, and for charts illustrating the principles expounded

[13] See page 187

[14] The author has always insisted that the problem of labor turnover is almost always a financial one. Those who have made a practice of reading economic literature will recall that in 1915, and the years succeeding, many complaints were made by business men on the subject of labor turnover. The fact was that prices were going up largely because the supply of money was increasing and the wage earners were entitled to increased wages for that reason Some employers were not willing to grant the raise voluntarily and paid for their shortsightedness by having to stand the loss of a heavy labor turnover. On the other hand, as prices come down and deflation sets in, the employer resorts to labor turnover to reduce labor costs. If laborers do not accept a wage reduction, they are discharged and others are employed at a lower wage The laborers who accept the wage reduction will in the long run probably be better off, since they will avoid the loss of unemployment Labor turnover has increased in importance with the passage of Federal and State unemployment insurance laws In most States, a reduction in the annual contribution rate, which applies to total remuneration of employees, will be allowed to employers with good employment records, and penalty rates will be imposed upon those with poor records. See notes to table on page 174

6. Steadiness of revenues in every enterprise is more or less tied up with steadiness in the level of prices. Since, on the whole, society benefits from a steady level of prices, everything possible should be done to maintain such a level.[15]

What makes for stability of gross revenues.—Stability of gross revenues will ordinarily be the result of one or more of four elements: (1) nature of business, (2) size of business, (3) possession of a monopoly, and (4) good management.

Nature of business in relation to gross revenues.—It is a notable fact that enterprises dealing in basic commodities and services have more stable revenues than those dealing in luxuries. Public utilities, for example, have more stable revenues than railroads, since the former minister to the public's

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[15] H Withers, "Business of Finance": "There can be no question that rising prices stimulate industry, while falling prices discourage it Rising prices put money into the pockets of producers and those who are responsible for keeping the wheels of industry spinning, and they take it out of the pockets of the rentier class living on the interest of saved or inherited money Between these two classes there is no doubt as to the interest of which should be encouraged from the point of view of human progress But we have to remember that the rentier class, though not apparently as useful as the active producer who is putting all his energy into making goods for our consumption, is nevertheless essential to the progress of industry There is another highly important consideration attaching to this question of a general rise in prices produced by currency inflation, and that is the fact that experience shows that the movement of wages does not as a rule keep pace with the movement of prices, but lags behind them, usually by an interval of three to six months. As long as this is true, falling prices are an advantage to the working classes and rising prices are against them, and so rising prices tend to produce dissatisfaction and industrial unrest It is possible that, as the organization and education of the working classes progress, they may be able to correct this tendency for wages to lag behind prices when prices are moving upwards But, as things are, the fact that rising prices, if continued too far and too long, tend to check accumulation and to produce industrial unrest, is a very serious drawback to put on the other side of the account as against the encouragement that they give to the energetic producer and to those who benefit from the extra profits produced by higher prices

"This being so, the ideal to be aimed at would seem to be steadiness in prices, in other words, it is the business of finance to consider whether it cannot regulate the general level of prices by somehow maintaining more or less constant equilibrium between the production of goods and the creation of currency "

See also L. D. Edie, "The Stabilization of Business", also "Business Cycles and Unemployment Report and Recommendations of a Committee of the President's Conference on Unemployment "

The author is not convinced that reasonable fluctuations in the price level do not make for social progress. The argument is too long to be given here. It follows, in general form, the principle of the survival of the fittest

It is true, for example, that increasing prices injure those with fixed incomes—but not the alert ones who at such times exchange their bondholdings for stockholdings Of course large institutions like insurance companies and heavily endowed eleemosynary institutions cannot readily make the exchange.

basic needs, whereas the latter are dependent on general business conditions and on such variable conditions as those represented by the size of the crops. In a severe depression, industries supplying durable and producers' goods suffer heavier losses than industries supplying non-durable and consumers' goods.[15a]

Effect of size of business on gross revenues.—Perhaps in more ways than one, mere size of business has a salutary effect in keeping revenues steady. The fact that large-scale production ordinarily makes for larger profits by reducing the cost per unit of output, has for a corollary the fact that large-scale production makes for steady gross revenues, since the lowness of the cost will permit relatively low prices and thus tend to make the article a common necessity. Moreover, enterprises characterized by large-scale production, up to a certain point at least, have a wide margin of profit when compared with smaller concerns, and can stand a reduction in price without closing down operations. Also, large concerns can absorb price changes in the basic raw material without reflecting them in the prices of their products. They have the means to carry temporary losses and also to purchase basic commodities in advance of price increases.[16]

Effect of a monopoly on gross revenues.—Other things being equal, a concern that enjoys a monopoly will have a more steady revenue than one that is subject to the vicissitudes of a competitive regime.[17] The reasons for this are too obvious to require exposition. But a word of warning is necessary. It has frequently been demonstrated that where competition is imminent, the cost of maintaining a monopoly may be so great as to be practically ruinous. This situation, for example, occurred years ago in the cordage business.[18]

[15a] For statistical proof of this statement, see W. L. Crum, "Corporate Earning Power in the Current Depression," Harvard Research Studies in Business, 1935.

[16] See H. S. Dennison in "The Stabilization of Business," by L. D. Edie; Crum, "Effect of Size on Corporate Earnings and Condition" (Harvard Research Studies in Business, 1934); S. Fabricant, "Profits, Losses, and Business Assets, 1929–1934," National Bureau of Economic Research, Bulletin 55.

[17] This statement is not necessarily to be used as the basis of the following arguments: monopolies make for steady revenues, steady revenues are good; therefore monopolies—State or otherwise—are good. The fallacy is that the steady revenue is good for the particular business, whereas the conclusion derived above assumes that whatever is good for the individual is good for the whole. A concern that has a monopoly, though it may be able to maintain a steady level of prices, may be very unprogressive.

[18] See A. S. Dewing, "Corporate Promotions and Reorganizations," p. 140.

Kinds of monopoly.—There are several kinds of monopoly, each of which has a different basis and a different effect on revenues:

1. *Patents.*—A patent enjoys a legalized monopoly for seventeen years, but is likely to be superseded by another patent of greater value.[19]

2. *Copyrights.*—Copyrights on literary and art productions may furnish the basis of a steady flow of revenue, but the market for them is usually limited. The large and steady sale of correspondence courses, for example, cannot be attributed to any special merit of the literature they contain—and this statement is not intended to belittle their values—but is attributable to the efficiency of the service and to marketing organizations.

3. *Control of raw materials.*—Since a monopoly which controls raw materials is generally illegal, this form of monopoly can hardly be considered of importance. But sometimes the supply of raw material—for example, suitable sand for fine cut glassware—is very limited in a particular, favorable locality. In such cases the monopoly, without being illegal, is none the less quite real. An advantage of such a monopoly, if the company deals in an unusual article of trade, is that the business can quite safely advertise its wares, in order to increase the public consumption, without thereby inviting competition that will profit by the publicity thus given to the wares.

4. *Limitation of sites.*—Such concerns as have docking facilities in large metropolises have a practical monopoly They are, however, subject to public regulation and the rates charged may reduce the profits, thus in effect causing the concern to give up the prospect of large income for certainty of income.[20]

5. *Large cost of reproducing plants.*—Our large railroads have virtual monopolies, since competition—when absolutely unregulated—involves the risk of too large an outlay of capital funds. All large concerns obtain more or less monopolistic advantages from large capital investments.

6. *Special franchises.*—A special franchise—such as one to use the public streets for gas pipes, electric wire conduits,

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[19] See M H Avram, "Patenting and Promoting Inventions" See, however, *ante*, page 4.

[20] See Munn v State of Illinois, (1877) 94 U S 113, the leading case on the right of the government to regulate business affecting the public interest.

or street railway tracks—usually grants a monopoly over the property concerned. No gas company, for example, is permitted under most public utility laws to lay pipes in a community already served unless the price proposed cannot be met by the existing concern, and even then the new concern would have to prove quite conclusively that it could provide the gas at the price it proposes. Such monopolies, of course, make for great stability of revenues, though, as we have seen in the example of the elimination of hundreds of miles of interurban electric railways by the extended use of the motor car, competition is always potential. For example, gas may be eliminated in some localities by the introduction of cheap electrical energy.

Good management as an element in stability of revenues.—Since stability of revenues has so much to recommend it, good management will aim at stability for its own sake.[21] This is not the place to point out how this aim can be carried out. One example must suffice. A fairly small concern, selling its product through the mail exclusively, found a product that it could produce very profitably and that could be sold in great quantities in one season of the year. It hired salesmen during that season, but found that the expenses of hiring salesmen for the rush season and then letting them go were very great. It therefore looked about for other products that could be marketed during the off seasons, and in this way not only increased its revenues, but made them more stable as a result of having a sales force through which it might at dull times exert continued marketing effort.

The operating ratio.—One of the most significant financial statistical units is that called the "operating ratio"; that is, the ratio of operating expenses to operating revenues. Given two concerns in the same line of business, the one with the lower operating ratio is likely to be better managed. We say *likely*, because one of the two competing concerns may seem to have excessive operating expenses, but may make up for the excess in lower fixed charges. The other concern may be energetic in its adoption of labor-saving devices; these will reduce the operating expenses but will increase the amount required for fixed charges or for maintaining a given rate of dividends. For this reason, two concerns should not be

[21] See the chapter on "Co-ordination of Production and Marketing," in L. D. Edie, "The Stabilization of Business."

given a comparative rating on the basis of their operating ratios alone. However, the operating ratio is an important unit and should always be made the basis of careful analysis and study.

Fixed and variable expenses.—It is a mistake to think that the operating ratio is a fixed percentage and that the operating expenses can be determined from year to year by applying the same percentage to the given revenues. Thus, if in one year the revenues are $100,000 and the operating expenses $60,000—the operating ratio in that year will be 60 per cent —it will not follow that in the next year, if the revenues are $150,000, the operating expenses will be $90,000. The fact is that the operating expenses do not all vary in direct proportion to the changes in revenues, since some of the operating expenses are fixed, or almost fixed, and others are variable.[22]

A simple example will make this point clear. One might think, at first blush, that the expenses of a small retail store would vary directly with the revenues, since the more goods that are sold, the more must be bought. But such items as rent, light, heat, insurance on fixtures, and clerk-hire are more or less fixed. The principle is well illustrated in the making and selling of a book. The fixed costs in manufacture are: (1) editorial work in preparing the manuscript for the printer, (2) setting the type, (3) proof reading, (4) correcting errors discovered while proof reading, and (5) locking the forms in the press. The variable costs are (1) press work, (2) paper, and (3) binding. Perhaps the revenues from an edition of one thousand books will just meet the costs—fixed and variable. If an edition of two thousand is run off instead

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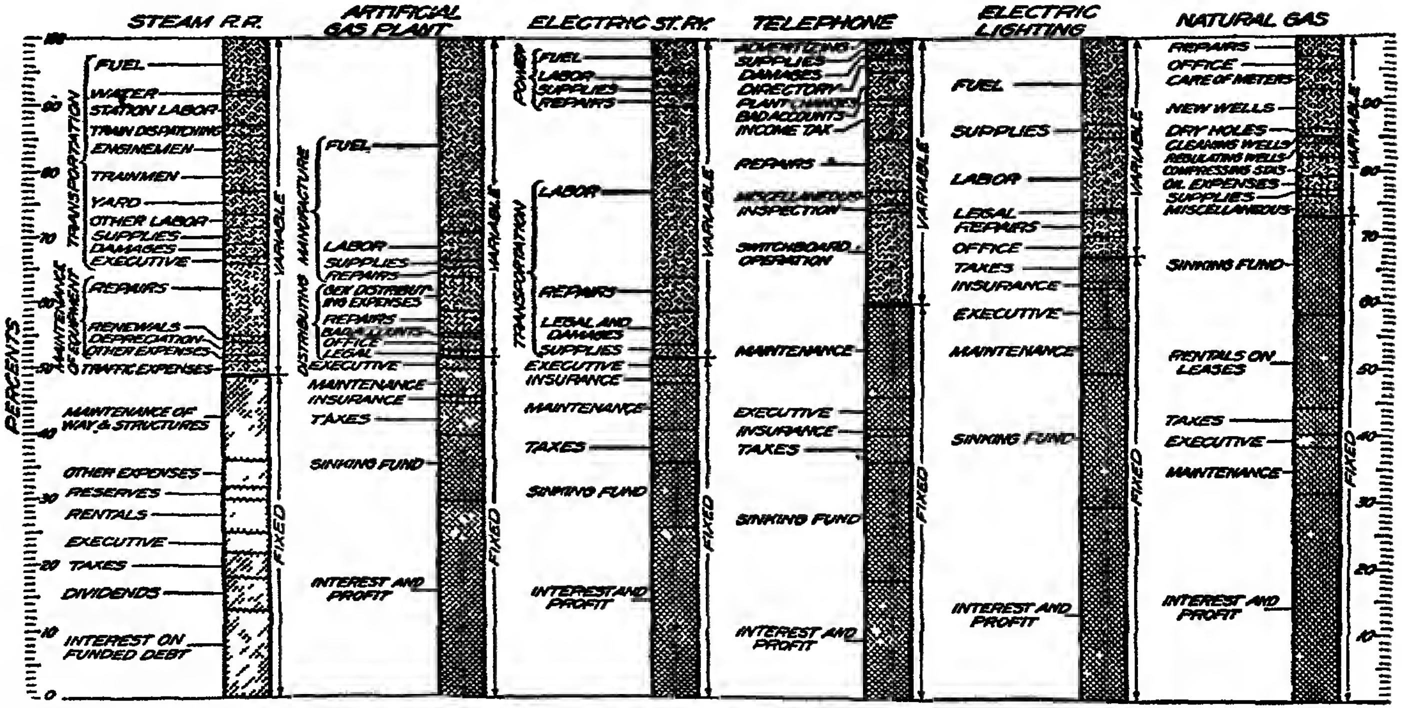
[22] See diagram on page 536 The following is a brief description of the situation as it will be found in industrial enterprises "This fixed expense in any plant usually consists of fixed administration salaries, office expenses, and a fixed selling expense The selling expenses include the salaries of the sales department and the usual advertising expenses to keep the product known, but exclude the commissions paid salesmen, which naturally vary in proportion to volume and hence are not a fixed expense It (the fixed expense) will also include a certain proportion of the indirect pay-roll of the factory, namely, that of the superintendent, the foremen who would be employed regardless of volume, the production department, a certain number of storekeepers to keep the storerooms in condition, tool-room keepers, checkers. inspectors, pensions, taxes, insurance, fire protection, a proportion of the engineering department, a proportion of the factory fuel which is needed to keep the plant on a going basis, telephone charges, water, depreciation, etc." From Vol IV, No 9, of the official publication of the National Association of Cost Accountants.

CLASSIFICATION OF FIXED AND VARIABLE CHARGES IN PERCENTAGE OF TOTAL OPERATING COST



Taken from S I Wyer, "Regulation, Valuation and Depreciation of Public Utilities," page 46.

of an edition of one thousand, on the second thousand all the fixed costs will be saved. Of course if a two-thousand edition is printed, the risk is run of not selling the second thousand and of therefore losing the variable costs on that thousand. We have here but another example of risks offsetting chances of enlarged profits.

The statements made above can be reduced to more understandable form if we use a concrete though imaginary example. Let us suppose that the fixed costs of setting up a book amount to $2,000, and that the variable costs, including selling expenses (leaving out overhead, however, since it would merely serve to complicate the situation unduly), are $2 a book.

If 1,000 books are printed and sold at $5 each, the result will be:

Receipts		$5,000
Fixed Costs	$2,000	
Variable Costs	2,000	4,000
Profits		$1,000

Each book sold would yield a profit of $1.

If, now, 2,000 books are printed and sold, the result will be:

Receipts		$10,000
Fixed Costs	$2,000	
Variable Costs	4,000	6,000
Profits		$4,000
Profits on last 1,000		$3,000

Each book would yield a profit of $2, but it would be fair to regard each of the first 1,000 as yielding a $1 profit and each of the last 1,000 as yielding a profit of $3. If, however, 2,000 books are printed, but only 1,000 are sold, the venture will result in a loss of $1,000; in other words, the concern must decide whether it will risk a loss of $1,000 in order to make the additional profit on the larger edition.

The break-even point.—It must be evident that a publisher would wish to know how many books he would have to sell in order to "break even." To solve the problem on the basis of the facts stated above, we may assume that x equals the number of books to be sold at the break-even point. The total income will then be x multiplied by the price of each book, or $5x$ dollars. At the break-even point, the total

income will just equal the total fixed and variable costs, which aggregate will be \$2,000 (fixed) plus $2x$ dollars (variable). Therefore,

$$5x = 2{,}000 + 2x$$
$$x = 667 \text{ books}$$

We may now express this computation in the form of a law.[23] The number of units that must be sold in order to

[23] Expressed as a formula

$$x = \frac{f}{p - v}$$

where.

x = number of units to be sold
f = total fixed costs
p = price per unit
v = variable cost per unit

The formula is a simplification of this equation $px = f + vx$
A mathematical manipulation will show that this formula agrees with that given by Walter Rautenstrauch in "The Successful Control of Profits," page 109 It should be noted, however, that x in Rautenstrauch's formula is the equivalent of our px, since Rautenstrauch's x is not the number of units sold, but the amount of sales, which will be the number of units sold multiplied by the price

Attention should be called to the fact that the problem usually contains another element, which turns on the principle known to the economists as the law of diminishing returns Included in the variable costs will be the element of selling costs These are not constant per unit It will cost the publisher more to sell the last books of an edition than to sell the first books. For example, if a publisher prints 2,000 books, his manufacturing costs beyond the fixed costs of \$2,000 may be \$1 a book While his manufacturing costs for each of the 2,000 books will remain \$2, his selling costs will not be the same for each of the 2,000 books. He may be able to sell 500 books at a cost of \$1 each, 500 more at \$2 each, 500 more at \$3 each; and 500 more at \$4 each If under these conditions a publisher sold the edition of 2,000 books, his income and outgo would be as follows

Income:		
2,000 books @ \$5.		\$10,000
Costs·		
Fixed manufacturing costs	\$2,000	
Variable manufacturing costs @ \$1 × 2000	2,000	
Selling costs		
500 @ \$1	500	
500 @ \$2.	1,000	
500 @ \$3	1,500	
500 @ \$4	2,000	9,000
Profit		\$1,000

regain the fixed costs and pay the variable costs up to the break-even point—in other words, the number of units that must be sold before a profit can be earned—is equal to the fixed costs divided by the unit price minus the unit variable costs.

In the above discussion it has been assumed that the variable costs are to a certain extent fixed; they are fixed in relation to the units of production. For example, we assumed that the variable costs would amount to $2 per book sold. We know by experience, however, that the variable costs will vary in respect to the unit as well as in respect to the number of units produced and sold. For example, if enough paper were purchased to print 1,000 books, the cost per book for paper might be ten cents; if enough books were produced to enable the publisher to buy his paper in carload lots, the cost of paper per unit might drop to seven cents.

The publisher, of course, would never care to publish exactly the number of books that would cause him to break even, for if he did, he would make no profit. He is compelled, therefore, to estimate the number he is likely to sell and take the risk of publishing that number. After his commitment is made, his break-even point will be equal to the sum of the fixed costs and the unit variable cost times the number of books printed, divided by the price.

Relation of fixed costs to fixed charges.—Fixed costs are in effect much like fixed charges, such as interest on bonds. However large or small the business is, they must be met. True, fixed charges are generally absolutely inelastic, while even insurance and taxes are likely to vary somewhat with the amount of business done. As to fixed costs, merely this statement can be made: the degree of elasticity which they possess, that is, the degree to which they can be varied when revenues increase or decrease, depends largely on the nature of the business and only slightly on the management. As we shall see, very little can be done to increase their elasticity or variability; good management must resort to other expedients to solve the problems they present.

At any rate, the principles that are now to be discussed will apply to fixed operating expenses and fixed charges.

Load factor.—We come, then, to a principle that has been sorely neglected by economists, accountants, and financial writers in the past, and of which only the engineers seem to

have taken cognizance—the load factor.[24] The load factor is defined as the ratio of average demand to plant capacity. This ratio may be written:[25]

$$\textit{Load factor} = \frac{\textit{Average demand}}{\textit{Plant capacity}}$$

Since the above principle is most frequently applied to public utilities, we can relate our explanation to a hypothetical electric light plant. Let us suppose a plant is constructed with engines and dynamos that have a capacity of 1,000 kilowatts; that is, if all the customers of the plant drew on its capacity at one time, the plant could meet their demands up to 1,000 kilowatts. If the plant were used at this capacity 24 hours a day and 365 days a year, its load factor would be 100 per cent. To put the matter very tersely, the plant would be earning every minute of the year, just as the interest on the investment in the plant runs every minute of the year. If, on the other hand, the plant were almost idle a good part of the time, the load factor might fall as low as 25 per cent or less, which means that the plant would work up to only 25 per cent of its capacity, though the interest on the investment would continue to run continuously at top speed. And, as we have seen, not only would the interest run at full speed, but so, also, would some of the operating expenses.

The ideal load factor.—The ideal load factor, then, is 100 per cent. The ideal, for example, to be achieved by the book publisher would be to print and sell as many books as could be run from the type till it should be worn down.[26]

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[24] It is surprising how few economists seem ever to have heard the word. One can find articles in economic journals in which the principles of load factors are discussed, though the authors in some cases seem not to know that the engineers have made extended studies of the question. See *ante*, pages 9–10.

[25] Sometimes the denominator, instead of being stated as the plant capacity, is given as "maximum demand." While it is true that usually the maximum demand will use the plant to capacity, it is better to recognize the fact that sometimes a company will not use its plant to capacity at any time of the year and that therefore a part of the capacity is wholly wasted.

[26] On the same principle—that of using up to the limit the elements that are included in fixed costs—we are made to realize that though our foreign trade represents, for many industries, only 10 per cent of our output, it is the "last" 10 per cent; it is the part which utilizes the otherwise unused portion of our fixed costs, and is, therefore, the part on which we must rely for a large share of our profits. This principle, too, is at the very foundation of the executive's search for sales. The last dollar of revenues is always the most profitable dollar, small wonder, then, that the executive goes after it. From the social viewpoint, this principle makes for wider and, we believe, in the long run, for more equitable distribution of the social product.

How may the ideal load factor be achieved?—The managers of a business charged with the actual job of making it pay must give thought to this problem of increasing the load factor. There appear to be two main ways, theoretically, for accomplishing this purpose. One way is to reduce to a minimum the fixed costs—fixed expenses and fixed charges; the other is to increase to the maximum the amount of business that can be done on the amount of fixed costs normally incurred. In practice, we shall see, the second method is the more important.

Law of proportionality.—The first thing a manager can do is to proportion his costs. Thus, it would be foolish to install boilers and engines capable of running a 500-kilowatt dynamo and then to install a 300-kilowatt dynamo. True, it may be anticipated that within a short time more capacity will be needed and some present sacrifice may have to be made for future welfare. At any rate, the law of proportionality must always be considered and should be applied whenever possible. Let us take an illustration that everybody can understand—a boarding house or small hotel. Such an establishment, let us assume, needs a minimum labor force of five people—a manager, a cook, a kitchen helper, a waitress, and a chambermaid—to take proper care of a house in which twelve people live. Therefore, to start a house with rooms for only ten people is to start off with a load factor certain to be less than 100 per cent. Now let us suppose that a cook and helper can do all the cooking for twenty-four people, a chambermaid can attend to the rooms of eighteen people, and a waitress can wait on only twelve people. If our boarding house accommodates twelve people, we will not get value for the wages paid the cook and the chambermaid. If our house were increased in size to hold twenty-four guests, we would do better. We could still manage with one cook, but we would have to add another waitress—whose full-time services would be utilized—and another chambermaid—only one-third of whose full-time services would be needed. The ideal arrangement, of course, would be a boarding house holding 72 guests, since for such an enterprise we could hire just the right number of servants to keep all employed all the time—three cooks and helpers, four chambermaids, and six waitresses.

In a hotel of this size, to round out the picture on this point of fixed and variable costs, the principal fixed costs would be

the wages of these servants, rent, and heat; and the principal variable expenses would be food, light, and laundry.

Increasing sales easier than reducing costs.—The discussion in the previous section may be summarized in a law as follows: the elements involving fixed costs must be so grouped in a business that the capacity of the plant will be equal to the least common multiple of the capacities of the several elements.

Instead of trying to reduce fixed costs to arrive at a proper relationship between costs and capacity, a business generally finds it more engaging to increase sales. Reducing costs is a negative, pessimistic policy; increasing sales is a positive, optimistic policy. Reducing costs means that men are to be "laid off"; increasing sales means that all operatives are retained in the factories and that salesmen are paid higher commissions.

Analysis of operating expenses.—The financial management of a business is interested in the operating expenses, not only because the expenses provide a measure of operating efficiency, but also because an analysis of operating expenses is necessary to a proper planning of the correct methods of raising and using current and fixed funds, to a proper maintenance of the owners' investments in the property, and to a proper reporting of income and outgo to the tax authorities.[27]

The financial department of a business will always do well to classify operating expenses somewhat as follows:

1. Taxes. The chief problem here is to order the affairs of the business in such a way as to minimize taxes. This is a problem for the finance department and is discussed below.

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[27] An analysis of each item in the profit and loss statement, for the purpose of discovering where correctives can be applied in an effort to produce larger net profits, can be made by reducing each item in the statement to a percentage of the sales and comparing the results with percentages for past periods To be sure, if in previous years the volume of sales or the volume of production were different from the corresponding amounts under consideration, comparison of percentages will not help the analyst to reach accurate conclusions unless he considers the principle of fixed and variable costs previously explained.

Professor Rautenstrauch, in his book "The Successful Control of Profits," pages 183 *et seq*, points out the shortcomings of the profit and loss statement, in itself, as a means of measuring the results of operations, he suggests the use of a "unit man" as a basis for measuring performance in a given industry and in comparing one industry with another. The "unit man" represents a man continuously employed throughout the year at direct labor. For example, to find the factory expense per unit man per month, the monthly total of such expense would be divided by the number of unit men employed during the month. This latter number would be attained by dividing the number of productive labor hours paid for by 200, which is calculated to be the number of

2. Maintenance of investment. This is the cost of keeping all the company's property in complete repair and up to one hundred per cent of its original value. Since the finance department is responsible for the maintenance of the owners' investment, we shall discuss this problem at length later.

3. Cost of doing business. In a manufacturing or mercantile concern this will include cost of materials and ordinary labor and selling costs. Obviously, the problem here is one for the purchasing department, the personnel department, and the sales department, and cannot be discussed in this book.

4. Overhead. This includes salaries of general officers, legal expenses, and so forth. A discussion of this is more appropriate in a book on management.

Taxation as affected by operating expenses.—In this book we cannot go fully into the subject of taxation in relation to financial management, but we must call attention to the importance of the subject and must point out and solve some of the important problems [27a]

Let us start with the general statement that however the item of taxes may be treated from an accounting and theoretical, economic standpoint, taxes represent either a regular periodic charge on the revenues, or an occasional and incidental charge. The latter class includes organization taxes on newly-formed subsidiaries, and inheritance taxes on the transfer through death of the interests of the owners of unincorporated businesses or of the shares of corporations and Massachusetts trusts, as well as taxes on the transfer of shares.[28]

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productive hours per month which one man working 48 hours per week 50 weeks in the year would have to his credit If each item to be measured is reduced to a "unit man" basis, comparison may be made between periods and between businesses

[27a] The growing importance of taxes is reflected in the tendency of corporations to present elaborate charts, tables, and analyses of tax expenditures in their annual reports to stockholders In view of the concern about rising taxes, it is interesting to note the conclusion of G A Steiner, in his study entitled "The Tax System and Industrial Development," University of Illinois Bulletin No. 58 (1938), "that heavy taxation has not acted as a check upon industrial development in periods of prosperity, nor has a light tax burden acted as a stimulus to industry in depression years"

For an enlightening study of the character of taxes paid by various types of business enterprises, see "Survey of Taxes Paid by Business in 1938," *Dun's Review*, April, 1939, and "Business Enterprise as Tax Collector and Taxpayer," *Dun's Review*, July, 1939

[28] These subjects have already been discussed See pages 87 and 171–182.

The principal periodic taxes are the income, franchise or license, and unemployment insurance taxes. Care must be taken to see that taxes are not incurred in localities where business income does not warrant the expense. For example, to use a very extreme case, Florida and Washington have placed heavy taxes on the use of trading stamps.[29]

Eliminating State taxes by engaging in interstate commerce only.—The managers of a business should study very carefully the law of interstate commerce as it affects taxability of business operations within States other than the State in which the principal office is located.

The problem may be stated thus: A corporation desires to do business in most of the States of the Union. What can it do to minimize State franchise taxes? The answer is, undertake operations in such a form as to bring them under the United States Supreme Court rulings establishing certain practices as acts in interstate commerce. Since, under the Constitution, Congress has control over interstate commerce, the States cannot, through taxation, place any burden on such operations, for by so doing they would trespass on the Federal domain.[30] What acts are and what acts are not included in interstate commerce? A company cannot "do business" *inside* a State without subjecting itself to franchise taxes. But it may take orders from the State and send its goods *into* the State without paying taxes for the privilege. Thus, a mail order business ordinarily does not subject the corporation to taxes in States to which letters and circulars are sent and from which orders through the mail are received. Nor does a corporation lose its status as one engaged in interstate commerce by selling through salesmen whose orders are sent to the home State, even though the salesmen use samples; but if the salesmen sell goods they carry, they will be doing business inside the State on behalf of the corporation. And it would seem that the fact that after the order is accepted the

[29] The income and franchise taxes are defined and described at length, in so far as they are peculiar to corporations, in the Prentice-Hall State and Local Tax Service The unemployment insurance taxes are treated in the Prentice-Hall Unemployment Insurance Service

[30] See *ante*, page 159. A recent decision of the United States Circuit Court of Appeals (Stone v Interstate Natural Gas Co , Apr 20, 1939) held that a corporation doing only interstate commerce can be subjected to a non-discriminatory State franchise tax. The attitude of the United States Supreme Court when it is called upon to review this case will have an important bearing upon the principles here set forth

goods are shipped to the salesmen to be delivered to the customer, does not constitute *intra*state commerce.[31]

Moreover, merely keeping an office in the State for the sole purpose of conducting interstate commerce does not constitute doing business in the State, though it comes pretty close to the line, and care must be taken not to go farther than merely maintaining an office from which salesmen can go or to which customers can come to give orders to be sent to the home State.[32] Sending goods to a warehouse in a State, from which warehouse goods can be sent to fill orders taken in that State, constitutes intrastate business for which the corporation will have to qualify by paying foreign corporation taxes. Installation of goods purchased, which by its nature cannot be accomplished by local workmen, is an act of interstate commerce. But if the corporation installs machinery, such as a soda fountain, that could be installed by local workmen, it will be held to be engaged in business inside the State and will have to pay the tax regularly imposed on foreign corporations.[33]

The income tax.—Income taxes are paid in general on net earnings, that is, on gross income less expenses. While no loyal citizen will desire to evade just taxes, he must for his own protection minimize taxes in order to compete on a fair basis with other concerns in the same line of business.[34]

The first principle to be followed is to charge as an expense, and not to the capital account, every item properly a charge against earnings. But several special tax problems will arise which cannot be solved by a knowledge of this elementary rule of accounting.

For the purpose of arriving at the net income which will be taxed, losses are deductible from income in the year in which

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[31] See Robbins v. Shelby County Taxing District, (1886) 102 U. S 489; Pembleton v. Illinois, etc Ass'n, (1919) 289 Ill 99, Loeb v Star & Herald Co, (1919) 187 N Y App Div 175; Dunn-Salmon Co v Edwards, (1915) 68 Pa Super Ct 340, International Text Book Co. v Pigg, (1909) 217 U. S 91, and International Text Book Co. v Tone, (1917) 220 N Y. 313 See "Doing Interstate Business," Prentice-Hall Corporation Service, pages 7000 *et seq*

[32] Cheney Bros Co v Massachusetts, (1918) 246 U. S 147

[33] As to the amount of the tax, and for other information about the tax laws of each State, see the Prentice-Hall State Tax Service. The propositions stated in the text are supported by Browning v City of Waycross, (1914) 233 U S 16, and General Ry Signal Co v Commonwealth of Va, ex rel State Corp Com, (1918) 246 U S 500.

[34] For the income and franchise tax rules in the several States, see the Prentice-Hall State Tax Service The discussion in the text from this point on is based on the rules applicable to the Federal income tax.

they are incurred. If a loss is sustained this year and the amount of the loss is not deducted, the only later recourse of the taxpayer is to file a claim for refund. Where a loss may be taken in any year—that is, where unnecessary depreciated property, such as an old machine, may be sold in any year and thus show a realized loss in the year in which it is sold—it is generally better to sell the property in years when the company has a taxable income. It is possible, however, as explained below, to deduct the loss from the net income of the two following years. Bad debts may be written off against income by a reasonable addition to a reserve or by writing off the amount of the bad debts in the year in which they are ascertained to be worthless

Net losses or deficits.—If a business continues to operate during hard times, it should keep its accounts just as carefully as it does at any other time, in order to be able to take full advantage of the loss deductions allowed by law. The Internal Revenue Code, as amended by the Revenue Act of 1939, provides that, beginning with 1940, a deduction is allowed in computing the Federal income tax for a "net business operating loss" sustained during the two preceding taxable years.[35] Thus, if *A* sustains a net business operating loss amounting to $11,000 in his regular business for the year 1939, and in 1940 has a net income of $5,000, he may apply the 1939 loss to his 1940 income and report no taxable income for 1940; furthermore, he may deduct the remaining $6,000 of his 1939 loss from 1941 net income, if any.

Salaries and the income tax.—Individuals and partners pay taxes on all the profits of their respective businesses, whether withdrawn or left in the business. The size of the withdrawals of profits, whether called salaries or profits, will therefore not affect the liability for taxes But the question of salary policy does arise in connection with corporations, joint stock companies, and business trusts. From the standpoint of the income tax, corporations can afford to reduce their income as far as possible by paying out the highest reasonable salaries. In the case of moderate-

[35] The deduction allowed to be carried over by the 1939 Act is for a "net business operating loss," as distinguished from the net loss shown in the prior years' returns Thus, if the return for a particular year shows gross income of $40,000 and deductions of $100,000, the net business operating loss to be carried over would not necessarily be $60,000. Certain adjustments, too technical to be explained here, must be made.

sized corporations which are owned by a small number of people who are also its managers, the highest reasonable salary should be paid, provided such salaries in the hands of the owners are not taxable at a rate greater than that payable by the corporation. Since every dollar of income that married men receive above $20,500[36] is taxed at a higher rate than would be payable by the corporation, ordinarily it will be advisable not to pay salaries to manager-owners in excess of $20,500, but to let the company use the earnings and report on the correspondingly larger net income.[37]

Insurance and taxation.—The Federal income tax law is designed not to throw any special burden on those who insure their property. Fire insurance, casualty insurance, and other similar insurance premiums are deductible from the income as expenses. However, premiums paid by a corporation on the life of an employee or officer are not deductible, unless the premiums constitute additional reasonable compensation.

Analysis of expenses as they affect the integrity of owners' investment.—In some lines of business—those having wasting assets, like timber, oil, and minerals—the operations of the concern use up the owners' assets. The assets are said to be depleted, and the process is called depletion Unless the managers of such concerns carefully withhold from revenues and reinvest sums equal to the value of the property exhausted in earning those revenues, the dividends given to the owners will represent in part a return of the owners' investment.

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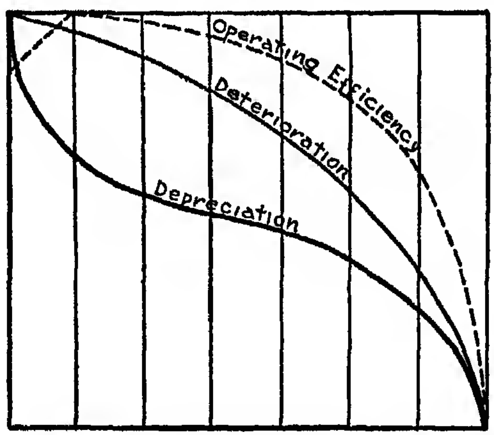
[36] This sum is arrived at as follows A corporation having a net income of $20,000 to $25,000 is taxed at 16 per cent on income over $20,000 We must find the amount of net income on which the individual will pay more than that rate of tax We know that the individual pays a normal tax of 4 per cent (see page 177) The question then to determine is, what is the largest amount of surtax net income (the amount of net income after credit of $2,500 for a married man) that will be taxable at less than 12 per cent? Reference to the statute shows that surtax net income in excess of $16,000 and not in excess of $18,000 is subject to a surtax of 11 per cent, making a total normal tax and surtax of 15 per cent, the next bracket of surtax net income is taxable at 13 per cent, making a total of 17 per cent Therefore the largest net income taxable at less than 16 per cent is $20,500 ($2,500 exemption plus $18,000)

[37] If the corporation has no need for the earnings in its business, it may be advisable not to limit the salaries as indicated, for the following reasons (1) corporations improperly accumulating surplus are subject to a special surtax (see footnote 23 on page 179); (2) individuals pay the same tax on salaries as on dividends, the corporation, on the other hand, pays less tax as the amount of salaries paid increases, provided they are reasonable, because reasonable salaries are deductible as a business expense. In other words, if the corporation cannot retain its earnings, it is advisable to pay the highest reasonable salaries.

But even in ordinary industrial and mercantile concerns the same thing may happen, not so quickly as in the case of the mining, oil, and timber companies and not so apparently, but for that reason all the more disastrously. Even the directors may not realize how the assets are being used up. Railroads, for example, have exhausted their assets through operations, because the funds have not been available to repair equipment, the equipment has gone on without repair till the disrepair has affected the service of the company, reduced its revenues, and brought it into the hands of a receiver. Almost any railroad receivership will reveal trouble of this kind.[38]

Theoretically, capital is self-perpetuating. A business that uses capital does not earn profits unless the income first bears the cost of maintaining the value of the capital used Our problem, then, is to discover what happens to impair this value and what may be done to maintain it.

Nomenclature of depreciation.—The terminology of depreciation is very complete, for the problem itself is large. Before we can attempt even such a limited discussion of the subject as



Relation of Depreciation and Deterioration to Each Other and to Operating Efficiency

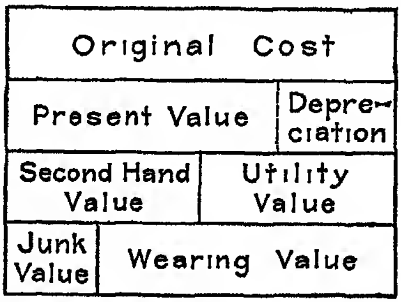
is in proper perspective to this book, we must define some terms that are frequently encountered in the literature of depreciation.

Depreciation is loss of value; deterioration is loss of substance. Operating efficiency is the ratio of present perform-

[38] The receiver of the Chicago, Rock Island & Pacific Ry. Co. in 1914–15 wrote off $21,264,777, thus turning a surplus of about $12,500,000 into a deficit of nearly $9,000,000.

ance to the attainable perfect performance. Let it be understood that there is no necessary connection between these terms; then much of the trouble that people have in understanding the whole subject will be cleared away. If we think of an ordinary touring car, we know that the moment the car is sold by the dealer, before it has been moved an inch from the warehouse, *it has depreciated*—usually by the amount of the salesman's commission. It has lost that much *value*. From that moment on, its depreciation will depend very largely on its operating efficiency, though some of the depreciation may be attributable to a change of style. For example, if the concern that made the automobile failed and doubt arose as to the possibility of obtaining repair parts, the value of that automobile would fall perceptibly. Those who have had experience with cars know that they climb a hill, for example, or "pick up speed" best after they have run from five hundred to a thousand miles—in other words, after they have deteriorated slightly and the parts move, one upon the other, most readily. After the high point in efficiency is reached, further deterioration means loss of efficiency, and as we have seen, loss of value.

The situation may be illustrated by the diagram on page 548, where the heavy line represents the depreciated value of the car, the light line represents the loss of substance by deterioration, and the dotted line represents the operating efficiency. It will be seen, then, that merely keeping the company's assets up to 100 per cent operating efficiency does not mean that the *value* of the corporate estate is being maintained.



Graphic Representation of Important Terms Used in Discussion of Depreciation

Dotted line indicates that the position of the division between depreciation and present value is constantly moving

The difference between depreciation and original cost value is called "present value." When the asset loses enough operating efficiency to warrant its displacement, its value will be "secondhand value" or "junk value," depending on whether it may be used for its original purpose or whether its value arises from what may be received for its parts if it is junked. If it is sold as a "secondhand" asset,

it will have lost utility value—that is, it will no longer be useful to the original owner, but since it may have some wear in it for a less prosperous or smaller concern, its total value down to junk value will be called "wearing value."[39]

These terms are more clearly indicated in the diagram at the foot of page 549.

Causes of depreciation.—What causes depreciation? A number of different causes operate to diminish the value of operating capital. These causes are divided into two classes, physical and functional These are again divided as follows:

I *Physical*	1 Ordinary action of nature 2. Wear and tear	Can be foreseen
II *Functional*	1 Obselescence 2 Accidents 3 Inadequacy 4. Governmental requirements 5. Changes in price	Cannot be accurately foreseen

These terms are almost self-explanatory. Illustrations will serve to indicate their meanings. The peeling of paint from the outside of a building illustrates action of nature. The wearing out of the rails of a railroad illustrates wear and tear, the chief cause of which is almost always friction.

When an asset is superseded in use by something more efficient or more attractive to customers, it is said to be obsolete. A concern in competition cannot afford to use such an asset. As a business grows, it can ordinarily afford to use larger-capacity tools. Since the old tools have to be taken out and hence lose their peculiar adaptability, they lose value suddenly—they become inadequate.[40] When the government prohibited the making of spiritous liquors, the breweries depreciated almost to junk value. If you pay $3,000 for an automobile and it has a secondhand value of $2,000, and the

[39] The generic term covering "junk" and "secondhand" value is "residual value" Original value, then, is equal to the sum of total depreciation and residual value.

[40] In the preface of the report of J. W Kendrick on the Missouri, Kansas & Texas Ry, made in 1917 to the receiver of that road, Mr. Kendrick recalled "that the road was built originally as a granger line, with grades conforming to the general surface of the territory traversed, light rails, narrow and undrained banks and cuts, light bridges and no engine terminals worthy of the name south of and few north of the Red River, the Texas boundary line The engines were light and mostly of antiquated design; some of better design but too light were unwisely purchased just before the advent of the present management."

maker then reduces the price of a new car to $2,500, your secondhand value will fall, by reason of the drop in price, to about $1,600. Changes in the general price levels of commodities may have somewhat the same effect.

What can be done to offset depreciation?—Three things can be done to offset loss of value

1. *Take care of the assets*—A well-oiled automobile will not deteriorate and lose its efficiency as quickly as one that gets no care. Of course this idea can be carried too far. If the care costs more than a new asset, we may permit the asset to wear out quickly and may replace it when it is worn out. We have been accustomed to following the latter practice in this country, where wages for repairs are high and machine-made replacements relatively cheap, whereas in Europe, where labor has been cheap, the practice has been to give assets great care. This form of offsetting depreciation means the expenditure of present funds and is sometimes called "present maintenance."

2. *Set up new assets to take the place of lost values.*—The word of caution that is needed here is that the method of accounting used by the company must insure that the added assets (or assets that are better than old assets and that replace these latter) do really offset the losses of depreciation. While we cannot go into a long accounting discussion, the problem is so important to financial management that we may explain exactly how loss of value in one asset is offset by adding other assets. Assume that a company owns a single asset purchased at the beginning of the year for $1,000 and that through the use of this asset $300, represented in cash (making no allowance for depreciation), is made during the year. The capital stock is $1,000. A balance sheet at the end of the year may read:

Machine..	$1,000	Stock	$1,000
Cash ...	300	Surplus .	300

Now suppose a new addition is added to the machine and that it costs or uses up $100 of the cash. Let us suppose that the depreciation of the old machine amounted to $100. Now we know that the actual profits of this company were $200, for while the company made $300 ostensibly, $100 of that was lost in the depreciation of the machine.

(*a*) The company may show the new asset on the balance sheet, but offset the loss incurred through depreciation by

setting up a corresponding account, called reserve for depreciation, on the liabilities side of the balance sheet. In this case the surplus is properly $200. After these steps are taken, the balance sheet will appear as follows

Machine	$1,000	Stock	$1,000
New asset	100	Reserve	100
Cash	200	Surplus	200

(*b*) A variation of this method involves an immediate subtraction of the reserve from the asset, thus

Machine	$1,000	Stock	$1,000
Less reserve	100	Surplus	200
	900		
New asset	100		
Cash	200		

This method is even better than the one just described, in that it shows exactly for what asset the depreciation is being allowed.

(*c*) Another variation of the same plan is to consider a certain amount of the cash, or some readily salable securities in which cash may be invested, as the offsetting factor of depreciation, instead of the machine. In this case the cash or the securities will be called a depreciation fund. Where the fund is used, the reserve will be set up as indicated in plan (*a*). The essential difference between this plan and the other plans is that this one has as its chief object the provision of a definite fund with which to replace the original asset when it is used up or worn out, whereas the other plans look merely to the maintenance in the company of values equivalent to the original investment in the asset. These other plans, then, leave open the question of how the funds will be found to finance the purchase of the new asset when it is needed to replace the old one. The balance sheet under this plan would look as follows:

Machine	$1,000	Stock	$1,000
Depreciation fund	100	Reserve	100
Cash	200	Surplus	200

(*d*) Another method is simply to write down the value of the original machine to its present value, that is, $900. This method, however, does not tell the complete story, although it does serve to substitute new values for those lost by wear

and tear. To make this point clear, let us examine the balance sheet. It would stand thus:

Machine	$900	Stock	$1,000
Cash	300	Surplus	200

If, now, we distribute a dividend to wipe out the surplus, our balance sheet will appear thus:

Machine	$900	Stock	$1,000
Cash	100		

Thus we come back to original assets of $1,000, but to offset the loss of $100 in the value of the machine we find the cash asset of $100

These variations of the second method of maintaining the stockholders' investment are sometimes called "deferred maintenance," because instead of spending money immediately to make good the losses of depreciation, sums of money equal to the depreciation are actually collected annually out of the earnings and invested in other assets or left in the company as cash. Let us be sure we understand this distinction between "present" and "deferred" maintenance. Take as an example a steel rail. A train runs over it and removes a thin layer of steel—somewhat thicker than it would have been had not nature with its moisture previously oxidized the rail. (Thus the rail deteriorates and depreciates through wear and tear and through the action of nature.) It is theoretically possible to replace the film of steel that was worn off—theoretically, by "present maintenance," we could keep the value in that rail. But in practice, the cost of putting a film of steel on the rail is prohibitive; and besides, as the rail wears down, to a certain point at least, we do not lose operating efficiency, but only substance and value. Hence, in place of present maintenance, through the use of a reserve we set apart assets to take the place of the lost value of the rail [41]

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[41] To complete the discussion and to emphasize further the distinction between "present" and "deferred" maintenance, we may show how the reserve appears in the other financial statement, the income statement We may assume that $10 was spent on repairs actually made on the machine during the year, and we may further assume that the company did a business of $1,000, incurring total operating expenses of $700 These operating expenses we break up as indicated in order to show the way in which the $10 is then reported

3. *The third method of taking care of depreciation is to make replacements and charge them to expense.*—The effect of this method is that instead of regarding the loss caused by depreciation as one of the costs of earning money, we charge the replacements as a cost of earning profits. Of course this plan will amply protect the assets, provided the replacements each year equal in value the loss by depreciation. Let us carry out our rail example, given above, on the basis of this method of offsetting depreciation. Let us assume that a railroad has projected ten miles of road at a cost of $20,000 a mile for the rails, that it builds a mile a year, and that the life of the rail is ten years; also that each mile is operated as soon as it is built. If now we assume that to replace the depreciation on each rail we set aside out of the earnings of each mile of road one-tenth of the value of the rail, after the ten miles are built we will be setting aside one-tenth of the value of each mile to make good the loss on each mile, or for the ten miles of road we will "reserve" ten-tenths of the value of a mile of rail, or just the value of one mile. In the eleventh year, however, the first mile of rail will have to be replaced. Under this plan we replace that mile out of earnings, charging the cost to "present" maintenance and setting aside nothing as "deferred" maintenance. The final result will be that out of the earnings, we will bring to the property each year, in respect to a single mile of rail, an amount equivalent to what the ten miles of rails lose in value through depreciation. Thus the value of the assets is maintained out of earnings.

The illustration we have selected is a very simple one, and one that could hardly be duplicated in any business. However, concerns that use this method usually install a new asset somewhat better than the old, in order to make certain that the new asset that is added each year to replace the worn out asset is equivalent to the lost values in all assets. Thus, if in the case above the old rails weighed seventy pounds to the yard and the rails laid in the eleventh year weighed one hundred pounds to the yard, there could be little question that the loss to all ten miles of rails during that eleventh year

Gross Income		$1,000
Operating Expenses, General	$600	
(Present Maintenance) Repairs	10	700
		300
(Deferred Maintenance) Less Reserve for Depreciation		100
Profits carried into surplus		$ 200

was being completely offset by the installation of the new and more expensive rail. But, after all has been said in favor of this method, the fact remains that it does leave uncertainties as to the exact amount of values contained in the properties, which uncertainties are removed through the use of the reserve methods, discussed under (2) above.

How much must be reserved for depreciation?—The answer to this question is, theoretically: as much as the assets lose in value through all the causes operating to depreciate them. But in practice this answer will not do, because we cannot ascertain what those losses are. So we must make estimates. These estimates all depend more or less on the estimated life of the assets for which the reserve is being set up. Then, too, they depend on the nature of the causes of loss of value that operate during that estimated life. But, in addition, the estimates of how much should be reserved from year to year depend on questions of financial policy that will be examined in succeeding sections. Let us, then, briefly discuss the practical methods of ascertaining the amounts that should be reserved for depreciation.

1. *Straight-line method.*—The simplest method is to reserve each year the same amount, this amount to be equal to the difference between the original value and the residual value—that is, total depreciation—divided by the estimated life of the asset.

2. *Working-hour method.*—The amount of depreciation charged under this method depends upon the number of hours a machine is used. The life of the asset is estimated on the basis of the total number of working hours the machine is capable of operating. The rate per hour to be charged for depreciation is the cost less scrap value, divided by the working hour life of the asset. The actual charge per year will be the number of hours the machine is used times the rate per hour. Thus, if a machine costs $10,500, has a scrap value of $500, an operating life of 40,000 working hours, and is used 10,000 hours in a particular year, the amount of depreciation to be charged against the machine for that year will be $2,500. This method of depreciation recognizes the fact that machinery depreciates more rapidly when operating at full time or overtime than when run part time.

3. *Production method.*—This method of calculating depreciation is similar to the working-hour method except that the

life of the asset is estimated as the number of units the asset is capable of producing. The rate per unit of product to be charged for depreciation is the cost less scrap value, divided by the total units of finished goods the machine will produce before it is worn out. The actual charge per year will be the number of units the machine has produced times the rate per unit. Thus, if in the example above the life of the machine were 40,000 units of production, the amount of depreciation to be charged against the machine if it produced 10,000 units during the year would be $2,500. This method recognizes that a machine wears out according to the amount of use given it, and is particularly applicable to assets producing a uniform product.

4. *Increasing charges.*—Since a new asset does not usually lose much value in the early years of its use, we may spread the total depreciation over the life of the asset as a charge increasing from year to year. Just how this is done we may leave to the accountant, but, since the financial manager is very much interested in the result, we may illustrate the method in a rough way as follows: Suppose that the asset has an estimated life of five years and that the total depreciation is $100. The charges will then run as follows:

Year	1st	2nd	3rd	4th	5th
Proportion of $100 set aside	$\frac{1}{15}$ +	$\frac{2}{15}$ +	$\frac{3}{15}$ +	$\frac{4}{15}$ +	$\frac{5}{15} = \frac{15}{15}$

5. *Decreasing charges.*—On the other hand, since the asset will need little repairing, that is, little present maintenance, during the early years of its use, the earnings of those years can stand larger charges for deferred maintenance. In using this method we simply reverse the order of the fractions, starting with $\frac{5}{15}$ and ending with $\frac{1}{15}$. This method is probably the one most frequently used, because it is conservative to write down the value of the asset as quickly as possible; also because to make the large charges at the beginning anticipates the unforeseen causes of depreciation, the results of which we described above as functional depreciation.[42]

[42] Three methods for providing a diminishing depreciation charge are described by H A Finney, in "Principles of Accounting," Chap. 39 These include: (1) uniform rate on diminishing value method; (2) diminishing rates on cost; (3) sum of years' digits or life-periods For an explanation, see the text cited.

6. *Methods taking into account compound interest.*—Other methods of determining depreciation take into account the compounding of interest on the amounts set aside for depreciation from year to year. One of these methods is known as the annuity method and another as the sinking fund method.[48]

7. *Depreciation proportioned to earnings.*—Some concerns write off arbitrary reserves proportioned to the company's business. If business is good, the assets will have been much used and, in the rush, repairs will perhaps have been neglected; moreover, the earnings will stand a larger charge than they will in the poorer years.

8. *Appraisal method.*—Under the appraisal method, an amount equal to the difference between the value of the asset as it is carried on the books at the beginning of the period and the value of the asset as it is found upon an actual appraisal at the end of the period, is charged to depreciation. This method has certain shortcomings. For example, during the early life of the asset the charges will be light and as the asset grows older, the charges will be heavier. Another disadvantage is that fluctuations in market value of the asset may not have any bearing on the actual wear and tear incurred.

9. *Composite life method.*—Under this method, the straight-line method described above is applied to the plant as a whole rather than to individual assets. To arrive at the composite life of the plant, the total depreciation is divided by the total of the annual straight-line depreciation calculated for each item. Thus, if the total depreciation of three assets is $27,000 and if the yearly depreciation for asset *A* is calculated by the straight-line method to be $1,000, for *B*, $1,500, and for *C*, $2,000, the composite life of the plant will be found to be six years and the rate of depreciation to be applied for the year, 16⅔ per cent. This method is not in common use, since it is recognized that depreciation should be provided in each class of fixed assets on the basis of the life of that class, and not on the basis of the life of the composite assets.

10. *Depreciation as an arbitrary sum.*—When an arbitrary sum is charged to depreciation, the assets of a company are

[48] See Finney, "Principles of Accounting," Chapter 39, for an explanation and example of the computation employed in these methods.

considered as a whole, just as they are in methods 7 and 9. This method is another which is not frequently used, though occasionally the profit and loss accounts of large companies provide for depreciation by making a round number charge that appears to be an arbitrary sum. For example, the General Chemical Company, a constituent of the present Allied Chemical & Dye Corp., in 1916 and 1917 made allowances for depreciation of $1,000,000 in round numbers.

Relation of depreciation to financial policy.—The way in which the method of handling depreciation reserves affects the questions of taxes, of rate regulation, and of dividend policies makes the whole problem of reserves important in the financial management of a concern. Here we shall briefly discuss taxes and rates, but we shall leave the relation of reserves to dividends to the chapter on dividend policies.

Relation of depreciation to taxes.—The Federal Income Tax Law permits, as it should, the deduction of deferred maintenance from earnings before reporting the net income on which the tax must be paid. However, taxpayers claiming depreciation deductions are required by the Treasury Department to substantiate all deductions claimed. Moreover, the offense of deducting excessive depreciation carries its own penalty upon a sale of the asset. For example, suppose, to save taxes, a $100 asset is written off at the rate of $20 a year and is sold at the end of the third year for $90. The total depreciation charged against the asset at the time of the sale will be $60, making its "present value" at the time of the sale $40. Since the asset was sold for $90, the profit on the sale will be $50 and this amount will have to be included in the taxable net income.

Relation of depreciation to rate regulation.—Most of the English-speaking communities now observe the principle that certain properties are so closely tied up with the public interest that the products or the service they produce should be sold at prices sufficient to yield no profit other than a fair return on the investment. If prices charged for the product or service are higher, the public is paying too much; if prices are lower, the investment will not receive a fair return; in the latter case it will practically be confiscated for public use. Moreover, a return that is not fair discourages further investment.

In nearly all discussions of what is a fair rate for public utilities to charge for their services, the question of deprecia-

tion arises. From the standpoint of the public, if the depreciation allowances are too large, the rates will be higher than they should be. From the standpoint of the owners, if the depreciation allowances are inadequate, the rates will not be high enough to pay a fair return, for no return is fair that does not permit the investment to be fully maintained out of earnings.[44]

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[44] For a typical discussion, see C W Gerstenberg, "Materials of Corporation Finance," pages 825 *et seq*, and R H Whitten, "Valuation of Public Service Corporations," Chapters XVII–XX See also P M Berkson, "Excess Depreciation Reserve and Rate Control," 36 *Columbia Law Review* 250 (1936)

CHAPTER XXVII

SURPLUS AND DIVIDEND POLICIES

Legal rules governing payment of dividends.—The law in this country is that dividends cannot be paid if the capital has been impaired.[1] This means, in effect, that the balance sheet must show a surplus and not a deficit. In England the test is current earnings; in other words, the income statement of the year is the guide.[2]

Where a dividend impairing capital has been illegally declared, the corporation cannot recover it from a stockholder who has received it in good faith unless the deficit created is greater than the outstanding stock. In the latter case the company actually becomes insolvent in the sense that its assets are less than its true liabilities, and the rights of creditors are affected.[3] Where a dividend has been discovered to be illegal, it is better for the company to formally rescind the dividend and make a peremptory demand on the stockholders for its return. In this event the dividend will not be taxable under the Federal law as income to the stockholder. If, however, the stockholder voluntarily returns it, he may be required to include it in his gross income on which normal and surtaxes are imposed.[4]

Rights of stockholders to compel a dividend.—The right to declare a dividend belongs primarily to the directors. We get a clear view of this subject if we assume that dividends are a goal to be reached by stockholders after two hurdles have been

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[1] This rule must be modified when applied to corporations with wasting assets, for example, corporations engaged in the exploitation of such assets as mines, oil wells, timber, and the like. The capital of such corporations must of necessity be impaired in the process of making profits

[2] See C F. Schlatter, "Payments of Dividends Before Restoring Impaired Capital," in *Journal of Accountancy*, March, 1923, for citation of English and American cases

[3] The rule given is the rule of the United States Supreme Court (McDonald v Williams, (1899) 174 U S 397; see also Hayden v Williams, (1898) 96 Fed 279) and of some of the States (Cottrell v Albany etc Co., (1911) 142 N. Y. App Div 148)

[4] See Prentice-Hall Federal Income Tax Service.

taken the first is the creation of an excess of assets over liabilities and capital stock, or stated capital; the second is the exercise of the discretion of the directors in declaring a dividend.[5] The second hurdle, it may be shown, was originally removed by the corporation's agreement that a dividend would be paid if the surplus existed And the courts have sometimes said that this contract to declare a dividend if a surplus exists may be implied, as, for example, where a preferred stock provision says that "the holders of this stock shall be paid dividends at the rate of 1¾ per cent on the first of January, the first of April, the first of June, and the first of October" In the second place, the second hurdle may be avoided by showing that the directors are not honestly exercising their discretion—in other words, that they are not acting in consideration of the welfare of the corporation and its stockholders, but are withholding dividends to further some private object [6]

It is very hard to lay down a rule that can be applied in all cases where the stockholders seek to compel directors to pay a dividend on the ground that not to pay it would constitute a fraud. In every case the facts are likely to be so complicated that a decision can be rendered by an equity court only after all the circumstances have been gone into very carefully. While the courts will not substitute their discretion for that of the directors, they will not wait until actual fraud has been proven before taking action. The order compelling Henry Ford to cause his company to pay a dividend at the instance of the Dodge interests is a case in point.[7]

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[5] At the annual meeting of stockholders of the Erie Railroad, held April 10, 1917, the following resolution was unanimously approved by a vote of all the stockholders present, except the proxy committee "Whereas, it appears from the yearly reports of the Erie Railroad Co that dividends on the preferred issues have been earned for several years past, therefore be it resolved, that the directors be requested to declare within thirty days from this date, dividends on both preferred issues in such proportion as are warranted, provided that same shall have been earned" At the ensuing monthly meeting of directors no action was taken on this resolution

[6] See W M Fletcher, "Cyclopedia of the Law of Private Corporations," Vol 11, §5325 *et seq*

[7] The Ford Motor Company was compelled to declare a dividend, the court holding the refusal of the directors to declare a dividend of more than $1,200,000 when the corporation had a surplus of $112,000,000, about $54,000,000 of cash on hand, had made profits of $59,000,000 in the past year, and had expectations of $60,000,000 the coming year, to be, in the absence of some justifiable

Practice in declaring dividends.—The following is a typical form of notice of dividends:

INTERNATIONAL
SECURITIES CORPORATION
OF AMERICA

Dividends for the quarter ending August 31, 1931, have been declared as follows:

Dividend No. 26	
6½% Preferred Shares	\$1.62½
Dividend No. 28	
6% Preferred Shares	1.50
Dividend No. 34	
Class A Common Shares	0.25

Payable September 1, 1931, to stockholders of record at the close of business August 15, 1931.

Stacy V. Jones,
Secretary

July 1, 1931

The general practice at one time was to close the books on the record date as of which dividends were to be paid, and not to open them for from ten days to two weeks, in order to give the secretary time in which to make up the list of stockholders to whom the dividend should be paid. Under modern practice, which is undoubtedly followed in the illustration above, the secretary prepares a list of the stockholders from the stock record book on the day as of which the dividend is declared—August 15, in the above case. The transfer books are allowed to remain open and records of transfers may be made without interruption. The dividend checks are sent to the persons whose names appear on this list and the company is discharged from liability[8] as between various persons claiming the dividend by reason of ownership of the stock. If the directors do not indicate a record date as of which the stockholders are entitled to a dividend, it is assumed

reason, an arbitrary exercise of authority which would give a court of equity the right to interfere Dodge v Ford Motor Co. (1919) 204 Mich. 459, 170 N. W 668.

[8] See A. Machen, "Modern Law of Corporations," Sec. 1370, for several cases cited following the rules given in the text above. See as to closing books, *ante*, page 111

that the directors intended the dividend to go to the stockholders of record on the day of the passage of the resolution. Many companies appoint a dividend disbursing agent, usually the transfer agent of the company, to handle the preparation of the list of stockholders entitled to dividends and to attend to all the details of the payment. The corporation deposits a sum of money with the agent sufficient to take care of the dividend, and the agent draws against this sum in paying the dividend. This service is rendered for a fee.[9] After a dividend has been declared, the amount of the dividend is a debt against the company. If, before the dividend is actually paid, the company unexpectedly fails through some calamity, the stockholders have a right against the assets as unsecured creditors up to the amount of the unpaid dividend. If the company actually had set apart a fund to pay the dividend and then failed, the stockholders would have the right to this fund.

Who are entitled to dividends.—Dividends must be divided among stockholders in proportion to their shares, though this rule, of course, is subject to the corollary that contractual rights represented by the classification of stock into common and preferred must be observed.

Unless there is a special contract to the contrary, stockholders of record on the day the dividend lists are made up are entitled to dividends, irrespective of when they became holders of the stock. In other words, dividends are not apportioned as is the interest on bonds. In the example given in the previous section, dividends are payable on the 6 per cent preferred stock at the rate of 6 per cent per annum or 1½ per cent a quarter, the dividend dates being approximately the first of September, the first of December, the first of March, and the first of June. If *A* bought a share of the stock from *B* on the first of August, *A* would get the 1½ per cent dividend paid on August 15. If, however, *B* sold *A* a bond, (interest payable June 1 and December 1) *B* would ordinarily require *A* to pay two months' interest to cover the period during which *B* held the bond since the last interest date, June 1. The company would pay six months' interest on December 1 to *A* and thus *A*, in effect, would get interest for the last four months of the period.

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[9] See Prentice-Hall Corporation Service for a detailed description of the practice followed in paying dividends.

Statutes in some States provide that interest may be paid on the amount paid on stock subscriptions, equivalent to the rate of dividends paid on the stock. It is always expedient to make similar provisions for a stock subscription that is to remain open for any length of time. The subscription agreement may accomplish practically the same purpose by providing that as payments are made, stock will be issued, "with adjustments for interest." Thus, if *A* subscribed for 100 shares of stock, under such an agreement, which stock was to receive dividends of 1½ per cent on the first of January, April, July, and October, and *A* paid $1,000 on the first of February, by paying interest on the $1,000 for the month of January, that is, $5, he could get ten shares of stock, on which he would receive on the first of April dividends amounting to $15.

Rights to dividends of different classes of stockholders.—Unless there is a classification of stock, authorized according to statutory requirements, giving one class of stock preference over another as to dividends, the shares of stock all stand upon the same footing and participate alike in the distribution of earnings. Nor, after issuance, can preferential dividend claims be given to any group of stockholders without the consent of all the stockholders, unless the charter is amended in pursuance of a statute. For example, if a company wished to raise money from its stockholders, it might, through an amendment to its charter, create some preferred stock and offer to exchange a certain proportion of the common stock of all the stockholders for preferred stock upon payment of a voluntary assessment On principle it would not be proper, however, for the company to provide that any stockholder who paid the assessment should have a preferential claim to dividends.

Kinds of dividends.—Dividends may be "regular" or "extra," and each of these may be divided into four classes—cash, stock, property, and scrip. Still another classification is that into "profits" and "liquidation" dividends.

"Regular" and "extra" dividends.—Sometimes the solutions of problems arising out of financial operations depend upon whether a dividend is a regular dividend or an extra dividend. For example, where bonds are convertible into stock and the stock is paying regular dividends, it is usual to allow the bondholder the stipulated rate of interest on his

bond from the date of last payment to the time of conversion, but to charge him with an amount equal to interest on the stock at the rate of the regular dividend paid thereon from the date of conversion up to the date of the next regular dividend. Adjustments somewhat on the same basis may be made by a contract of sale between successive owners, as for example where *A* sells stock to *B* to be delivered on a certain date, "adjustment to be made in respect to accumulated dividends." While as a matter of law the right to a dividend does not arise until it is actually declared, a contract such as is here contemplated would justify the seller in requiring the purchaser to pay not only the stipulated price, but in addition the interest thereon from the date of last declaration of a dividend up to the time of delivery, at the rate of the regular dividend.

What is a regular dividend and what is an extra dividend is generally settled by the directors of the company. Large corporations usually number their dividends and label them as regular or extra. Sometimes the distinction depends on whether the dividends are paid out of current earnings or out of accumulated earnings. Where it is necessary to establish whether a dividend is regular or extra, recourse must be had to all the surrounding circumstances that bear upon the situation.

Extra dividends are frequently called "melons." As we shall see (page 568), a declaration of extra stock dividends was stimulated by the provision of the Federal Income Tax Law giving the Secretary of the Treasury power to tax undistributed surplus. While stock dividends are usually "extra" dividends, they may become regular for a period, as in the case of the General Electric Company, which for several years distributed dividends in the form of special stock at the rate of 5 per cent. Sometimes, when it is inconvenient to pay the regular dividend in cash, stock will be substituted.[10]

A word of warning should be given about extra dividends Honest practice, it would seem, would require that extra dividends should not be declared suddenly. Stockholders should have some warning that a melon is to be cut in order

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[10] In December, 1920, the American Agricultural Chemical Co explained that its regular dividend was being paid in stock because farmers were holding crops for higher prices and the company therefore had to conserve its cash resources till the farmers' indebtedness to the company was liquidated

that they may know what can be expected from their stock in case they wish to sell.

Extra dividends as part of a conservative policy.—Frequently, when corporations find profits mounting, their directors will wish to increase the dividend rate without leading stockholders to believe that the new rate is to be expected in the future. In such an event the increase will be called extra. For example, the United States Steel Corporation in 1923 declared its regular 1¼ per cent dividend on its common stock and an extra dividend of ¾ of 1 per cent. In 1924 and again in 1925 extras of 2 per cent were paid. In 1926 the regular dividend became 1¾ per cent and the extra dividend was reduced to ½ of 1 per cent. The company thus left itself in position to drop back to the regular dividend of 1¾ per cent at any quarter without permitting the stockholders to criticize or claim disappointment. The company paid only the regular rate in 1927 and 1928, and in 1929 again declared an extra dividend of 1 per cent In 1930 no extra dividend was paid. The 1¾ per cent regular dividend was paid from June 29, 1926, to June 29, 1931, inclusive; it was reduced to 1 per cent quarterly in July, 1931. Another reduction to ½ per cent was made in Mar., 1932. Thereafter no dividends were paid, except 1 per cent in 1937.

Liquidation dividends.—Dividends paid in the ordinary course of business and not as a step toward the complete or partial suspension of operations are properly designated "profit dividends," whereas dividends paid out of properties that are being surrendered, whether paid in kind or first converted by the company into cash or some other form of wealth, are called "liquidation dividends." It will be noticed that the distinction here does not turn on the question of whether the dividends are paid out of current earnings or out of accumulated earnings. This classification is important, not only in connection with income tax problems, but also in connection with distributions to different classes of stock [11]

[11] See for relation to taxes, Peabody v. Eisner, (1918) 247 U. S 347; Lynch v Hornby, (1918) 247 U S 339, Lynch v Turrish, (1918) 247 U S 221 (Amer. Fed. Tax Reports, pages 2995, 2902, and 2986 respectively). For relation of liquidation dividends to the rights of preferred and common stockholders, see *University of Pennsylvania Law Review*, February, 1931 In liquidation, preferred and common shareholders share alike unless there is some limitation in either the articles of incorporation or the stockholders' contracts. Thus, if there are surplus assets, the preferred and common share *pari passu*, if there are none, the preferred gets no preference. However, in cases where the preferred under its contract is entitled to a repayment of capital before the

Cash dividends.—Corporations may pay out of cash, dividends equal to but not in excess of the surplus of the company The question of law that arises here is: can a company that has a surplus, but whose cash is tied up in non-distributable assets, borrow money with which to pay dividends? And the answer is: undoubtedly, yes. But the question of expediency is not so easily answered, for there are times when borrowing money with which to pay dividends is not inexpedient.

Take this situation. A company is expanding quite rapidly. It is going to need new capital, which it will be inexpedient to raise through a bond issue A prime requisite to the economical sale of its stock is to give that stock a high market value; this aim can be accomplished by establishing and maintaining a fair dividend rate. To meet the dividend requirements, temporary loans may be sought and stock sold, and thereafter the company can use its earnings for dividends instead of having to "plough them" into the property.

To be sure, corporations would hardly attempt to raise a loan ostensibly for a dividend payment. Instead, they borrow money for operating purposes and use the cash from revenues to pay the dividend.

Stock dividends.—A stock dividend is a distribution of surplus through a pro rata issuance of additional stock.[12] Such is the usual definition. In practice it amounts to a division of the "corporate pie" into a greater number of slices. Indeed, it is best looked upon as a form of readjustment of the company. A stock dividend means that the corporation is to have a larger capitalization over which to spread earnings.[13]

Corporations that undertake expansion programs which require the outlay of large amounts of capital from year to year and which immediately result in greater profits, may

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common is paid anything, the following question arises if there are surplus assets, are the preferred shareholders entitled to anything beyond the repaid capital? In the two cases concerning this problem that have been adjudicated, the courts held that the preferred was not entitled to participate in surplus assets For criticism of these decisions, see the article cited See also page 759.

[12] Sometimes the stock dividend is declared by the simple process of increasing the par value of the company's stock In 1921 the Chicopee Mfg. Co declared a 300 per cent dividend on its common stock by increasing the par value of a share from $25 to $100 and by increasing the aggregate par value from $150,000 to $600,000

[13] The Federal Trade Commission compiled a list of important stock dividends declared during 1922 The companies represented numbered 328 and

justifiably adopt a policy of paying stock dividends instead of cash dividends. The stockholder ordinarily has no complaint, since the surplus earnings are worth more to him when they are reinvested in the corporation than if they were distributed to him as a cash dividend. Those stockholders who do not wish to increase their interests in the company may sell the stock received as a dividend and obtain cash to be invested by them as they please. Other reasons that prompt a corporation to pay a stock dividend are: (1) to reduce the market value of the stock outstanding. The corporation pays the same rate of dividend on the larger number of shares instead of increasing the dividend rate on the number originally outstanding, thus veiling the huge profits it has made and obviating criticism usually incited by large returns on capital. Furthermore, the reduction of the price permits wider distribution of the securities. (2) To distribute the surplus without consuming the available cash. The corporation gives the stockholders evidence of the increase in their investments without interfering with the company's operating facilities.[14]

While the declaration of a stock dividend is within the power of the directors, in practice the matter usually has to be submitted to the stockholders, since the corporation will likely have to amend the certificate of incorporation to increase the amount of capital stock.[15]

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the distributions amounted to over $2,149,151,245 The largest single distribution made during the period was a 400 per cent stock dividend of the Standard Oil Co of New Jersey, which amounted to $393,353,200 Another report of the Federal Trade Commission made in response to Senate Resolution No 304, 69th Congress, 2nd Session, Approved Dec 22, 1926, Sen Doc No 26, 70th Cong 1st Session, indicates that the absolute increase in stock dividends in the period 1920–1926 over that of 1913–1919 among corporations paying any stock dividend at any time during the fourteen year period, was 586 62 per cent, while the absolute increase in cash dividends for the same corporations for the same period was only 94 07 per cent The reduced earnings of 1930 encouraged a change from cash dividends to stock dividends Thus, an analysis of dividend actions from January 1 to September 30 in 1930 and in 1929 showed 727 stock dividends in 1930 as compared with 483 in 1929. The undistributed profits tax in the 1936 Act (see footnote 24) encouraged stock dividends in spite of the fact that the 1936 Act changed the method of taxing stock dividends (see page 570) With the removal of the high undistributed profits tax rates, there was a decline in the number of stock dividends Undoubtedly the present method of taxing stock dividends acts as a deterrent to declaration of this form of dividend.

[14] See page 570 for relation of taxation to stock dividends

[15] Stock dividends raise the question of fractional shares For example, if a 20 per cent stock dividend is distributed, the company may have outstanding

Where control is not a factor, as is the case with the great majority of stockholders of large corporations, the distribution of a stock dividend enables stockholders to get immediate cash returns through the sale of the stock received. We mean, since stock dividends are usually declared as "extra" dividends and the regular rate is usually maintained, and since the stockholder usually counts only on a regular dividend, he may sell the stock received in the dividend and thus get cash

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a large quantity of fractional shares. A stockholder with seven shares, for example, would get one whole share and two-fifths of a share The company may pay dividends on these fractional shares but would not ordinarily give them any right to vote Sometimes fractional shares are not used, and in those cases three methods of handling the fractional interests are applied (1) the corporation pays cash for fractional interests, (2) it provides for the issuance of scrip, or (3) it provides for the accumulation of credits These methods are illustrated below

(1) The Chicago Railway Equipment Co in the early part of 1918, for example, distributed a special 20 per cent stock dividend, but announced that no fractional shares would be issued, stockholders were given the option of receiving the fractional share in cash or of receiving a full share by paying the company in cash the difference between the fractional share and the value of a full share The Standard Investing Corporation and the Kroger Grocery & Baking Company follow the practice of selling at market, a few days in advance of the dividend payment date, an amount of stock equal to the aggregate of fractional interests resulting under the dividend declaration The net proceeds obtained are distributed pro rata among the stockholders entitled to fractional shares A statute in Connecticut prohibits the corporation from issuing fractional shares and requires it to sell to the highest bidder any fractional shares which stockholders have failed to combine by purchase or sale.

(2) Under the second usual method of handling fractional interests, the corporation issues scrip to stockholders entitled thereto, who may obtain full shares when the scrip is presented with similar scrip aggregating a full share Frequently, a definite time is set during which the scrip may be accumulated and consolidated into whole shares, after that time expires, the scrip is redeemable but not susceptible of consolidation In such cases, since it is desired to get the scrip out of the way, a provision may be made that no dividends will be paid nor voting power granted till the exchange is made A market is generally created for the scrip The Columbia Gas & Electric Corp follows a plan similar to the one described and sets aside an amount of stock equal to the aggregate of fractional interests The scrip certificates are distributed to those entitled to fractional shares and are exchangeable into full shares upon presentation of scrip aggregating one full share Dividends are paid on the stock set aside against scrip At the end of a certain time the reserved stock remaining is sold and the proceeds, including the dividends on the stock set aside against scrip, are distributed pro rata to the scrip holders

Various methods of using scrip are in vogue See for a description of some of them, "Fractional Shares Under Stock Dividend Declarations," by William C Waring, Jr, *Harvard Law Review*, January, 1931

(3) In cases where the corporation has adopted a policy of paying dividends in either cash or stock at the option of the stockholder (see page 572), fractional interests are handled under a plan which provides that an account be kept for each stockholder who has elected to apply his cash dividends to the payment

to invest in other companies in pursuance of a good investment policy requiring diversification of investments.

Relation of taxation to stock dividends.—Under the provisions of the Federal income tax law,[16] a stock dividend is taxable if it gives the stockholder an interest different from that which his former stockholding represented, and is not taxable if it is not. Thus, if a corporation has only common stock outstanding and a stock dividend of such stock is distributed, the stock dividend is not taxable.[17]

The corporation may not resort to non-taxable stock dividends to reduce the amount of apparent surplus and thus be relieved from the surtax imposed for improperly accumulating surplus.[18]

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of stock The account is credited with fractional shares to which the stockholder becomes entitled Full shares are issued as soon as the fractions accumulated aggregate one full share The stockholder receives no dividends or voting rights on his credits Under this scheme there is no limitation of time during which the credits may be aggregated Some of the companies following this plan permit the stockholders to purchase additional credits at any time in order to make a full share The Associated Gas & Electric Co., which has so-called optional dividend stock, uses a plan similar to the one described, as does the Cities Service Company

[16] In 1920, the Supreme Court, in the celebrated case of Eisner v Macomber, 252 U S 189, 40 S. Ct 189, 3 A F T R 3020, held that a dividend in a corporation's common stock paid to the then stockholders was not income within the meaning of the Sixteenth Amendment of the Constitution Under the assumption that the Court's decision applied to all stock dividends, Congress, in 1921, modified the law by providing that "a stock dividend shall not be subject to tax," and that provision was continued in all the Revenue Acts, up to and including the Act of 1934. In 1936 The Supreme Court, in Koshland v Helvering, 298 U S 441, 56 S Ct 767, 17 A F T R 1213, held that a stock dividend was income within the meaning of the Sixteenth Amendment if the dividend "gives the stockholder an interest different from that which his former stockholding represented" As a result of this decision, the 1936 and subsequent Acts provided for the taxation of stock dividends as far as permitted by the Amendment

[17] If a stock dividend is taxable, the amount of the dividend is taxed in the same manner as a cash dividend If a stock dividend is not taxable, the cost basis is apportioned between the old and new stock For example, if 100 shares of stock cost $9,000, the basis of each share is $90, if the stockholder receives a 50 per cent stock dividend, he will then have 150 shares, and the basis of each share will be $60. If the stockholder sells 100 shares for $7,000, his recognized gain is $1,000

[18] Under the Internal Revenue Code, as amended by the Revenue Act of 1939, the income tax on corporations with normal-tax net income over $31,964 amounts to 18 per cent (see page 178), whereas the sum of the normal tax and the surtax on the income of individuals runs as high as 79 per cent The drafters of the law therefore anticipated that a number of people, in order to avoid the high surtaxes, would turn over all their income-producing property, whether simple investments or operating property, to a corporation, permit the income

Property dividends.—Where a company has unnecessary "fungible" property, such as securities of other companies, it may find it expedient to distribute them to the stockholders through a dividend.[19] Such stock may have been originally acquired to be held for legitimate purposes and the corporation may later have discovered that it is inexpedient or illegal to hold the stock. Distribution in the form of a dividend may be resorted to rather than a sale and the distribution of the cash, in order to prevent a decline in the price of the stock that would result from a sale of any large block.[20] Notable examples of other property dividends were the distribution of Anglo-French bonds to the stockholders of munition companies,[21] Liberty bond distributions,[22] and distributions of "liquor stocks" shortly after the enactment of the prohibition laws.[23]

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to remain in the corporation and thus pay only the corporation rate To meet this possible avoidance the law provides for the imposition of a sur tax upon the "undistributed section 102 net income" of any corporation that persists in accumulating an unnecessary surplus, equal to the sum of the following (a) 25 per cent of the amount not in excess of $100,000 plus (b) 35 per cent of the amount not in excess of $100,000

A separate provision of the law (Sec 500, Internal Revenue Code, as amended by the Revenue Act of 1939) imposes a heavy surtax upon personal holding corporations which accumulate income The tax is imposed upon the "undistributed Sub-chapter A net income" at the following rates 65 per cent of the amount thereof not in excess of $2,000, plus 75 per cent of the amount thereof in excess of $2,000 Generally speaking, a personal holding company is any corporation 80 per cent of the gross income of which for the taxable year is derived from royalties, dividends, interest, annuities, and gains from the sale of stock or securities, and more than 50 per cent in value of the outstanding stock of which is owned by not more than five individuals at any time during the last half of the taxable year In computing the number of individuals who hold the majority of the outstanding stock of a corporation, all members of a family in the direct line as well as the spouse and brothers and sisters are counted as one

[19] The reasonable market value of the property received is a dividend subject to the Federal income tax Reg 101, Art 115-10

[20] When Swift & Co was compelled by the United States Government to dispose of its subsidiary companies engaged in the food businesses, it distributed the stock of these subsidiaries to its stockholders

[21] Hercules Powder Co , on March 6, 1917, announced a dividend of 47 per cent, payable in Anglo-French bonds at 94; that is, a $1,000 bond was given to the holder of $2,000 worth of stock

[22] Example: Union Bag and Paper Corp in 1918. The reason for this distribution of Liberty bonds was that the tax exemption feature was more valuable in the hands of individuals than in the treasury of the corporation.

[23] A dividend may be paid in bonds From the standpoint of the taxability of such bonds in the hands of the recipient, under the Federal Income Tax Law they will be regarded as cash equivalent to their market value. Doerschuck v. U. S , (1921) 274 Fed. 739; Amer. Fed. Tax Reports, Vol. II, page 1475.

Scrip dividends.—A scrip dividend amounts to the distribution of promissory notes to the stockholders When a corporation without available funds feels that it ought to give the stockholders of the present the earnings of the immediate past instead of withholding all title to these earnings for the benefit of future stockholders, it will use the scrip dividend. During the World War the American Tobacco Co. substituted scrip for cash in paying its regular 20 per cent dividends.

Since a stock dividend increases the amount of stock outstanding on which dividends can be maintained only through increased earnings, scrip will be used instead of stock to distribute accumulated earnings whenever the prospects do not fully justify the expectation of larger earnings and dividend distributions for the future Scrip may or may not bear interest.

In order to avoid the undistributed profits tax imposed by the Revenue Act of 1936, several corporations paid dividends in the form of interest-bearing notes.[24] Southwestern Development Company, for example, issued $2,040,-300 of its 4 per cent notes maturing July 1, 1943, in payment of dividends on its common stock.

Dividends payable in stock or cash.—A practice of giving the stockholders the option of receiving their dividends in cash or in stock has grown up during recent years, especially among public utility and other large corporations with programs of expansion that render reinvestment of earnings

[24] The 1936 Act imposed a surtax on the net income of corporations in an amount measured by the undistributed net income. The rates of surtax were graduated in brackets, the lowest rate was 7 per cent of that portion of the undistributed net income which was not in excess of 10 per cent of the adjusted net income, and the highest rate was 27 per cent of that portion of the undistributed net income which was in excess of 60 per cent of the adjusted net income Corporations tried to avoid the surtax by payment of dividends in every possible form It became abundantly clear that the surtax on undistributed profits, as imposed by the 1936 Act, was harmful to business and to the country (For a summary of the reasons for the act and objections to it, see M Wertheim, "The Undistributed Profits Tax and What to Do About It," *Harper's*, Feb. 1938.) The term "surtax on undistributed profits" did not appear in the 1938 Act, but the principle was retained, since the result of the method of computing the tax on corporations with large incomes was to bring about a maximum rate of 19 per cent if no dividends were distributed, and a minimum rate of 16½ per cent if the entire net income were distributed to shareholders. See footnote 21, page 177 The Revenue Act of 1939, amending the Internal Revenue Code, eliminated the last vestige of the surtax on undistributed profits

advisable. The corporation informs the stockholder that he may either receive his dividend in cash or apply the cash to the purchase of additional stock. Choice must be made within a certain number of days after receiving notice. Some companies that have established the cash or stock dividend as a definite policy have arranged that all dividends will be paid in cash unless notice to the contrary is received from the stockholder; others apply all dividends to the purchase of shares unless notice is received by the corporation that the stockholder elects to receive his dividends in cash.[24a]

This method of paying dividends has also been adopted by some corporations as a means of satisfying investors in preferred stock who look for a speculative increase in their investment. By accepting dividends in the form of common stock, the preferred stockholder accepts an opportunity to participate in any extraordinary rise in profits.[25]

What is surplus?—All along we have not assumed that the reader is versed in accounting. We have found, strange as it may seem to people who do understand the fundamentals, that many people who have studied bookkeeping do not understand the expression "surplus." Here we shall not attempt any nice theoretical exposition, but shall explain briefly what is meant by the word surplus in order that even those who have had no bookkeeping training may understand it. For those who know accounts, we suggest passing on to the next section.

Surplus is an excess of assets over liabilities. If we examine the assets of a company, appraise them and list them, according to American practice, on the left-hand side of the paper—and then list all the liabilities, including the capital stock, on the right-hand side—we shall ordinarily find that the assets exceed the liabilities. Therefore, to make the balance sheet live up to its name—to make it balance—we write an item under all the liabilities sufficient to bring about the balance, and we call that item surplus. The reader will understand, then, that the expression "paying dividends out of surplus" is not strictly true. We actually pay the divi-

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[24a] See footnote 15, page 568, for method of handling fractional shares

[25] In instances where the dividend is payable in cash or stock at the option of the stockholder, the stock dividend is taxable under the Federal income tax law even though under other circumstances the stock dividend might be non-taxable.

dends out of assets (that is, wherever it is the usual cash dividend) and measure the amount that can be distributed from the assets for this purpose by that surplus item.[26]

While we are on the subject, we may say a word or two more about the true nature of surplus When reduced to a finality, the assets side of a balance sheet describes the property of a company, and the liabilities side explains what disposition should or could be made of that property. Let us take a simple example.

Assets		*Liabilities*	
Land and Buildings	$150,000	Capital Stock	$150,000
Machinery	25,000	Accounts and Notes Payable	75,000
Inventories	35,000	Surplus	75,000
Accounts Receivable	40,000		
Cash	50,000		
	$300,000		$300,000

Here the property amounts to $300,000. Of this (turning to the liabilities) $75,000 belongs to the creditors and should, as it falls due, be paid to them, $150,000 represents original investment of the stockholders and should be used for the purposes for which it was contributed, namely: (1) to be conserved in order that it may be turned back to the stockholders if the company dissolves, and (2) to earn profits; and $75,000 represents the profits that, in the discretion of the directors, may be turned over to the stockholders as dividends. Sometimes the surplus and capital items are placed close together, since they together represent the equity of stockholders in the corporate property.

If, now, we break up the surplus and call the excess of assets over liabilities partly surplus and partly undivided earnings, thus: surplus $50,000, undivided earnings $25,000, our purpose would be to indicate that the "surplus" is to be retained and that the stockholders may expect to get in dividends the undivided profits. That is to say, we intend to keep $50,000 ("surplus") in the business, but the $25,000 of excess assets designated by the expression "undivided profits" may be divided as dividends. This nomenclature is used by

[26] It is hardly necessary to inform the reader that in practice balance sheets are not compiled in the way we have indicated, but for purposes of *financial* analysis they may be regarded as having been constructed in just that way For the sake of simplicity, too, we omitted to mention reserves; these we shall take up later

the banks. A better scheme for ordinary corporations is to substitute for "surplus" some such term as "reserve for working capital," or, "appropriations for working capital." Either of these expressions may be taken as an abbreviation of the more complete explanation: "Here is the amount of excess of assets over liabilities which the directors wish to retain or reserve in the business to provide working capital." Where such a nomenclature is used, the "undivided profits" becomes "surplus" and thus we get back to our original statement that surplus is the measure of dividends.

What is the surplus when stock has no par value?—We have seen that dividends can legally be declared only when the corporation has a surplus. In other words, the corporation cannot impair its capital by the payment of a dividend. From the preceding explanation it is clear that the surplus is the excess of the assets over the liabilities, including in the latter the amount of capital stock. If the capital stock has par value, the amount of capital stock is readily determined; it is the number of shares outstanding multiplied by the par value per share. But if the capital stock has no par value, what amount represents the capital stock; in other words, how much of the stockholder's investment represents capital that cannot be impaired by the payment of a dividend?

The answer to this question usually depends upon the wording of the statute under which the non-par stock is issued—that is, upon the definition of capital contained in the statute. In some statutes, capital is the consideration received for the non-par shares. In other statutes, the board of directors has power to determine by resolution, within a certain number of days after the non-par stock has been issued, the part of the consideration that shall represent capital. The portion not designated as capital is termed "paid-in surplus" and is available for dividends, as shown on page 594. If the directors neglect to fix the capital by resolution within the time limited, the total consideration is treated as capital. In still other statutes, unless the capital in respect to the shares without par value is fixed in the certificate of incorporation by assigning to each share a stated value, the capital will be assumed to be the consideration received for such shares. In the second and third classes, the directors may from time to time add to capital by transferring amounts from surplus. Most statutes provide that the capital may

be decreased by transferring amounts to surplus if the rights of creditors are not impaired, in all such cases, the statute must be carefully followed.

Where the statute is specific in its definition of capital, as in the above three classes, there is no more difficulty in fixing the surplus for the corporation that has stock without par value than for a corporation that has only stock with par value.

But some statutes do not define capital with respect to non-par shares. The rule to be followed in such cases is that in the absence of some other arrangement made by the corporation and the purchaser of the stock at the time of the issuance of the stock, the entire consideration paid for the non-par stock must be treated as capital. This rule is based upon the principle that investors purchasing stock regard the payment made to the corporation for the stock as capital to be used in carrying out the purposes of the corporation, and do not expect, in the absence of information to the contrary, that any part of the price paid by them will be converted to surplus to be available for distribution to stockholders.

Profit-sharing contracts.—The ascertainment of the profits available to the owners of a business is often complicated by the presence of profit-sharing contracts with employees. The interpretation of such contracts is further complicated by the question of whether taxes should be deducted before the profits in which the employee is to share are determined. Certain legal decisions lead to the conclusion that if the intention to calculate profits before taxes are deducted is not clearly expressed, the courts will hold that the compensation of the participating employee should be calculated as the agreed percentage of profits *before* any deduction for taxes is made.[27] Since most employers probably desire to share with employees only after all costs, including taxes, have been provided for, care should be taken to express the intention explicitly.[28]

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[27] Stanley v Leary, et al., (1923) 199 N Y. Supp. 617, Amer Fed Tax Reports, Vol. III, page 3260.

[28] This may be done in language substantially as follows: "To determine the exact amount of your compensation, we intend to regard the amount of compensation as part of the cost of manufacture (or as an expense of the business) Therefore, any taxes, computation of which depends upon the ascertainment of net income, would be computed on a basis which would include the deduction of the compensation as a part of the cost of manufacture (or as an expense of the business) from the gross receipts, notwithstanding

When a contract does contain a clause such as is suggested in the footnote, the following dilemma arises: The tax which is to be based upon the profits, less the contingent share of profits, cannot be determined until the share of profits has been determined, since the deduction of the share thus to be given to the employees is allowable as a business expense. On the other hand, the share, being based on profits less the tax, cannot be determined until the tax is determined. We cannot here go into a full explanation of the manner in which to determine the amount of the bonus, but we shall present in the footnote a problem and solution based upon the 1939 income tax rates.[29]

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the fact that the exact amount of the compensation would depend in turn upon the ascertainment of the amount of such taxes. The income (and profits) taxes computed on such net income shall be deductible in computing the amount (or percentage) of the profits due you."

See also page 156, for managers' shares as a means of profit-sharing, and page 690 for subsidiary as an aid in profit-sharing.

[29] A president of a corporation is to receive a bonus of 5 per cent of the profits after Federal taxes have been paid. The profit before deduction of Federal taxes, at the rate of 18 per cent, is $100,000. What is the president's bonus?

The following formula will determine the amount of the bonus:

$$\text{Bonus} = .05\,[\$100{,}000 - .18\,(\$100{,}000 - \text{Bonus})]$$

Solving the formula as follows, the bonus is found to be $4,137.23.

(a) 20 Bonus = $100,000 − .18 ($100,000 − Bonus)
(b) 2,000 Bonus = $10,000,000 − ($1,800,000 − 18 Bonus)
(c) 2,000 Bonus = $10,000,000 − $1,800,000 + 18 Bonus
(d) 2,000 Bonus − 18 Bonus = $10,000,000 − $1,800,000
(e) 1,982 Bonus = $8,200,000
(f) Bonus = $4,137.23

The above formula will apply only in the case of corporations which are subject to the general method of taxation. It will not apply to corporations with incomes of less than $25,000, or to corporations with incomes slightly over $25,000, which are subject to the alternative tax described on page 178.

The problem can be solved mathematically, without the use of the formula, by the trial and error method, as follows:

$100,000 × .18 = $18,000, First trial income tax
($100,000 − $18,000) × .05 = $4,100, First trial bonus
($100,000 − $4,100) × .18 = $17,262, Second trial income tax
($100,000 − $17,262) × .05 = $4,136.90, Second trial bonus
($100,000 − $4,136.90) × .18 = $17,255.36, Third trial income tax
($100,000 − $17,255.36) × .05 = $4,137.23, Third trial bonus
($100,000 − $4,137.23) × .18 = $17,255.30, Fourth trial income tax
($100,000 − $17,255.30) × .05 = $4,137.23, Fourth trial bonus

Since the fourth trial bonus is the same as the third trial bonus, it is *final*.

Corporate deficits.—If a company has not made a profit but has lost ground, the assets side of the balance sheet will be smaller in amount than the liabilities side, and hence, to make the balance sheet balance something will have to be added to the assets side. This item we may call "deficit," or "corporate deficit," or "loss," or, as the accountants call it, "profit and loss." Where such an expression as this last phrase is used, the reader of the balance sheet, if inexperienced, must bear in mind that it gives rise to a somewhat paradoxical situation; if it is found on the assets side, it represents loss; if, as is sometimes the case in accounting statements, it is used on the liabilities side instead of what we have defined as surplus, then it is the measure of profits

Methods of eliminating deficit.—We have already pointed out that a company cannot pay a dividend if, at the time of the proposed distribution, the company's balance sheet reveals a deficit. We may now suppose that its balance sheet has shown a deficit for some time and that a turn of events brings to the company large current profits, but not enough to extinguish the deficit Must the stockholders wait or can they get at these profits? For example, a balance sheet appears at the beginning of a year as follows:

Assets		*Liabilities*	
Land	$100,000	Capital Stock	$250,000
Buildings	50,000	Accounts and Notes Payable	50,000
Inventories	50,000	Reserves	25,000
Accounts Receivable	25,000		
Cash	50,000		
Deficit	50,000		$325,000
	$325,000		

The company earns $40,000 during the year. What can it do in order to pay dividends?

In the first place, intangible items may be written into the assets. The deficit may be due to certain expenses which any concern would have to incur to get to the point where this company now finds itself. Has it not, then, built up the asset that we have already referred to, "going concern value"?[30] Is not the $50,000 an asset instead of a loss? There may be a deficit arising from past operations, to be

[30] See page 15 Some accountants object to writing up any intangible asset that has not been purchased.

sure, but if the company is going to be able to earn $40,000 consistently year after year, it may consider that its business as a going concern is worth the income capitalized at, say 8 per cent, or $500,000. Since it has tangible assets of $275,000, it may write into its balance sheet, on the assets side, the intangible item of goodwill valued at $225,000 (that is, $500,000 less $275,000); the deficit disappears and a surplus of $175,000 will appear on the liabilities side. Thus we get rid of the deficit, the $40,000 of profits in the new balance sheet at the end of the year will turn up as a surplus, and the result will be that a dividend can be paid.

In the second place, an appraisal of all the property may be made and it may be found that some of the property has been carried on the books at less than its value. Thus, in the above example, the land may now be worth $150,000, if that value were brought into the balance sheet, the deficit would disappear.[31]

In the third place, reserves may prove to be too liberal and some of these may be converted into surplus, wiping out part of the deficit.

In the fourth place, under the statutes of most States corporations may reduce their capital stock, and in this case the corporation may ask the stockholders to consent to a reduction of the capital stock under the terms of the statute.[32] If a reduction of $50,000 in capital stock is accomplished, again the deficit of $50,000 will disappear and the new profits of $40,000 will be available for dividends.

Fifth, if the capital stock is made up, let us say of 2,500 shares with a par value of $100 per share, the corporation

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[31] For an example, see A S Dewing, "Corporate Promotions and Reorganizations," page 29 Corporations filing reports required under the Securities Exchange Act of 1934 must answer certain questions relating to increases or decreases in *investments*, in *property*, *plant*, and *equipment*, or in *intangible assets* resulting from substantially revaluing such assets For an interesting analysis of the answers to the questions by 208 large industrial concerns, see S Fabricant, "Revaluations of Fixed Assets, 1925–1934," National Bureau of Economic Research, Bulletin 62 (1936)

[32] Devaluation and decapitalization were frequently employed in the early thirties to avoid failure tendencies and to assist in restoring earning power The reverse split-up—that is, one share for four held, for example (instead of four shares for one, as in a regular split-up)—was one of the methods used to accomplish the decapitalization See L P Starkweather and F L Valenta "Devaluation and Decapitalization," *Barron's*, Oct. 1, 1934

may wipe out the deficit by changing to non-par stock, through an amendment of the certificate of incorporation. Thus, capital stock in the balance sheet would appear as $200,000 represented by 2,500 shares without par value. Similarly, if the capital stock is made up of 2,500 shares of non-par value stock, the corporation may wipe out the deficit by changing the shares to $80 par value each. Thus, capital stock in the balance sheet would appear as $200,000, represented by 2,500 shares with a par value of $80 each

If any of these five methods is used, the result will be legal provided an honest survey of the situation shows that the conditions upon which the arrangement should be made actually exist. It must be remembered, however, that frequently this question, like most other questions of corporation law, is governed primarily by statutes, in the light of which the opinion of judges must be read and construed. Moreover, the question of fraud often enters a given situation and where fraud enters, equity courts, in which most dividend questions are decided, become most alert. We shall mention some of the circumstances later which seem to alter the general rule that dividends may be paid "out of" a "balance sheet surplus." In most of these cases, we shall see that an element of fraud enters to cause the modification of the rule.[33]

Analysis of assets to determine if a surplus really exists.—In every case equity and expediency demand that the excess of assets over liabilities upon which a dividend is based be a *bona fide* excess. For example, some of the assets may be entirely fictitious, such as bond discount, or may be temporarily capitalized expenses, such as "organization expense"[33a] and "deferred charges to expense." The extent to which such assets should be eliminated has been fully discussed in

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[33] See pages 593 and 596

[33a] The practice among accountants is to capitalize organization expenses if they are large in amount, and to write them off over a period of years, if they are not very large in amount, they are usually charged off in the year in which they are incurred For purposes of the Federal income tax, however, organization expenses, such as incorporation fees and attorneys' and accountants' charges, are capital expenditures and are not deductible from gross income in computing the Federal income tax (Reg. 101, Art 24-2). The Treasury Department has ruled, furthermore, that such expenses do not constitute a proper item to be added to the cost of any physical property and provided for through annual allowance for depreciation.

books on accounting and here we may very properly say that good accounting principles should be used in determining the disposition of such assets. From a legal standpoint, very little light is thrown on the subject by the American cases. In fact, the author has seen none which is satisfactory. Whether cases growing out of the income tax will be applicable to questions arising under the general heading of dividend policy of corporations where income tax is not involved, is very doubtful. The critical reader who needs more light on the legal aspect of the subject is referred to the English cases, some of which are mentioned by A. Machen in his excellent book entitled "Modern Law of Corporations."

Where assets have an undoubted existence, the question may very well arise: is the present value of these assets equal to the value at which they are carried in the balance sheet?

In the example given on page 578, for instance, the deficit may really have been much larger than $50,000 because the buildings that originally cost $50,000 may have depreciated in value to the extent of $25,000. From an accounting standpoint, this error can be corrected in three ways: (1) the item "Buildings" may be made to read $25,000; or (2)

Buildings . . .	$50,000	
Less depreciation. . . .	$25,000	$25,000

or (3) an offsetting reserve may be entered on the liability side equalling the amount of depreciation. If the third method were used, the liability side would be increased by an item of $25,000, "Reserve for Depreciation." In all three cases the deficit would be $75,000 instead of $50,000.[34]

From the standpoint of corporation finance, one ought to have little difficulty in establishing the fact that an asset is worth more or less than the amount stated in the accounts. For example, a director can easily determine whether the valuation of $50,000 placed on the building represents original cost a number of years ago and whether the building really has depreciated $25,000. The problem is a little bit more difficult from the standpoint of investment, where the prospective investor is not permitted access to the books of

[34] A fourth method involves the setting up of a special fund to take care of depreciation—this method would likely not be used where the company has a deficit For a more complete discussion see the previous chapter, "Management of Income"

account but must rely upon the balance sheet itself and upon such implications as he may deduce from an examination and comparison of the balance sheets over a number of years. While this problem of the investor is important and interesting, we must dismiss it here since the subject properly belongs to a book on investments and not to a book on business finance.[35]

What reserves should be set up.—In order that no mistake may be made in the payment of dividends by using a surplus inflated by over-valued assets, directors will do well to take a list of the company's assets as shown by detailed balance sheets, and ask themselves in respect to each item, "is the value of these assets stated in the balance sheet too great."

All the fixed assets in a balance sheet may be treated for depreciation in the way indicated in the preceding section. Enough was said on this subject in the previous chapter. Here we need merely say that the question of depreciation reserves should be reviewed by the financial management as the first step in the formation of a correct dividend policy.

Another group of assets which the directors must examine carefully is that known as receivables—accounts, notes, and bills receivable. They represent, generally, moneys due the corporation for goods and services sold and delivered. Some of them may be uncollectible and it is customary, therefore, to set up on the liability side, in order to reduce the surplus, an item known as "Reserve for Bad Debts" equal to the estimated amount of receivables that will not be collected. Probably the managers can get at the accounts themselves to make the estimate, but they may find it simpler to use the

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[35] Failure to maintain the property is often coupled with what seems to be a wantonly extravagant dividend record But we must make allowances for circumstances and not condemn too readily even if we disapprove thoroughly. When a corporation is in need of funds, it must seek them from investors in its securities, to whom nothing makes so great an appeal as demonstrated income It is natural, therefore, that the management should seek to keep up the record of dividend payments Remember that the policy of paying dividends at the expense of maintenance does not involve taking money physically from one place and using it in another; it consists most frequently of insidious procrastination in making repairs or inability to comprehend how new equipment may be necessary to keep abreast of new times. J. W Kendrick, the railroad expert who made a report in 1917 on the Missouri, Kansas & Texas R R for the receiver, said in effect that the former management utterly failed to recognize the coming changes in transportation methods and paid dividends from 1906 to 1914 amounting to $4,160,000 which had better have gone into property

banker's method. If a concern sells $300,000 worth of goods in a year and the terms of credit are thirty days, about one-twelfth of the total sales for the year will be represented at any time by present receivables. That is, the company ought not to have good accounts receivable much in excess of $25,000. If the concern has $75,000 of accounts receivable, probably a large part of them are worthless, and a reserve for bad debts for as much as $50,000 would not be too large. When this method is used, allowances must be made for seasonal changes in sales and for any other special circumstances that may affect the amount of receivables that normally could be expected at a given time.

What are sometimes known as the working assets may also need scrutiny. If a company has a large amount of raw material, material in process of manufacture, and finished products, it may have listed amongst its assets a quantity of unsalable goods which ought either to be written down or offset by a reserve. In times of falling prices, such as the years 1920 and 1921, prices of inventories may fall very rapidly and even though the goods can be sold, the values placed in the balance sheet to represent them may be too high.[86]

Assets such as patents, copyrights, patterns, publishers' plates, and so forth, should not be carried at large values by a concern that makes any pretense at conservatism. Of course,

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[86] See table No 9 on page 464. When prices began to rise, some American companies set up special reserves against the contingency of a drop in the value of inventories The American Woolen Company set aside in 1917 a reserve for shrinkage in value of inventories amounting to $7,000,000 and added $7,500,000 to it the following year, the reserve at that time being equal to 39 per cent of the value of the inventories. The company came through the panic of 1921 with its $32,000,000 surplus practically unimpaired, at the same time maintaining the 7 per cent dividend on its common stock.

Another example is the Diamond Match Company, which is one of the few industrial companies of this country with a dividend record extending over 50 years. A part of its success in maintaining regular dividends is undoubtedly due to its conservative reserve policy. For example, in 1917 its inventory increased about 100 per cent to $9,202,044. In the following year "with realization of the fact that many of the chemicals it employs would be subject to sharp price declines should the war end, the company set up as a reserve against the December 31, 1917, inventory figures the sum of $1,700,000, an amount equal to nearly 20 per cent of the book value of the inventory. As a matter of fact, the total reserve must be not far from $2,000,000, because at the end of 1916 a special reserve to 'protect stocks against price decline' of $300,000 was made" *Boston News Bureau*, March 20, 1918. The company has continued its conservative reserve policy.

the given corporation may be turning a considerable portion of its revenues into assets which will produce income for a number of years and it would be unfair, therefore, to count the cost of these assets as expenses to be deducted from revenues.[37] The conservative practice is to give them a reasonable value at the inception and to write them off over their period of usefulness. A patent, for example, with a life of seventeen years, may easily lose its value through competition with some other device, by change in fashions, or from some similar cause, and it would be more conservative, therefore, for the value of the patent to be written off over a period of ten years than over the full period of seventeen years.

On the other hand, even after the expiration of a patent, there may still remain a valuable asset in the form of good-will created by years of association in the minds of the public of one trade mark with a patented article. For example, after the expiration of the Bayer patent for the manufacture of aspirin, other companies manufactured the product. Many users of aspirin, however, still insist upon buying Bayer's. Thus the patent, in effect, has had a life of more than seventeen years.

Reserve for expansion and promotion.—Sometimes the directors will desire to undertake a campaign of expansion that will use the earnings of the company for a number of years, and they will indicate in their reports to stockholders that the latter need not expect dividends out of these appropriated earnings. We have already referred to the reserve "Appropriation for Working Capital," that is found in some companies' balance sheets. The Nippon Yusen Kaisha[38] has a reserve for the construction and expansion of the fleet; this is merely an entry on the liability side of the balance sheet notifying the stockholders that a part of their earnings has been "ploughed into the property," namely, into new boats and new equipment.

Two other methods of solving this problem are available: one is to turn the earnings over to the stockholders and to get the needed funds through the sale of securities, and the other is to keep the funds in the company but to pay a stock

[37] "I have found in organizing industrials that trade marks when properly protected are quite as valuable as bricks, mortar and machinery" C. R. Flint, "Memories of an Active Life," page 306

[38] See C. W. Gerstenberg, "Materials of Corporation Finance," page 624.

dividend on the basis of the profits they represent. As we shall see later, either of these two options is preferable to simply "ploughing in the earnings."

One form of expansion that such a reserve may facilitate is the acquisition of companies to effect a horizontal or vertical merger. This type of consolidation is explained on page 616.

Obligation reserves.—We saw in the chapter on sinking funds that wherever a specific fund is set aside to redeem an obligation at maturity, the fund should be protected on the liability side by a reserve. Before dividends are paid, directors should examine all their obligations represented by security issues to see that the funds are being maintained and that any reserves required by agreements in these security issues are properly set up.

In these days of high taxes a reserve for taxes is usually necessary. For example, at the present time the Federal income taxes imposed on corporations with large incomes amount to 18 per cent of the profits (see page 178), and are payable about March 15, although they may be spread over the later months of the year. If the corporation showed profits of $80,000 for its first year of operations and the balance sheet of December 31 was balanced with a surplus amounting to $80,000, $14,400 of this amount should be taken out of the surplus account and turned into a reserve for taxes.

Reserve for retirement of preferred stock and bonds.—Closely akin to sinking fund reserves are reserves created arbitrarily for the retirement of securities that the corporation is not obligated to redeem, but which are subject to call.[39] The corporation creates the reserve in order to be able in the future to redeem the securities and thereby reduce fixed charges, strengthen the position of the company, and make available to the common stockholders a larger return on their investment.

Patent protection reserve.—A company that has control of a market through its patents, or whose business is likely to be affected by patents, must be prepared to acquire other patents that affect the business, or to make arrangements to operate under a patent held outside of the company. Fur-

[39] On October 2, 1931, the United States Supreme Court decided in U. S v. Kirby Lumber Co. that if a corporation issues bonds at par value, and repurchases the bonds at less than par, the excess of the par value over the purchase price is income for the taxable year. See page 303 for statutory exception

thermore, it must be in a position to maintain litigation to protect the patents it holds. An adequate patent protection reserve would enable the corporation to meet any situation affecting its patent position that suddenly presented itself. Even after the patent has expired, the reserve may be maintained to protect the goodwill of the patented article by advertising.

Insurance and welfare reserves.—Most people understand the service of an insurance company in distributing risks. We cannot go into that theory here. Where, however, a company has a number of properties located at different places, subject to imminent hazards for protection against which insurance companies would demand heavy premiums, it may be better to let the property insure itself. For example, if a shipping company has ten similar ships and the premium to cover one is one-tenth its value, the corporation can afford to lose a ship a year in place of taking out the insurance.[40] In such cases the corporation, instead of paying premiums to insurance companies, usually sets up an "insurance reserve" and invests the amount that would be turned over to the insurance company in the extension and improvement of its properties. In effect, as far as the shipping company that we had under consideration is concerned, the eleventh ship may be bought with what otherwise would go to the insurance company and if one of the eleven ships is lost, the company is no worse off than it would have been had it taken out the insurance.[41] Of course, the directors must be careful to guard against the loss of property that must be replaced immediately; such a necessity calls for an immediate investment of funds which might not be available if the money were invested, not in an insurance policy, but in fixed assets that cannot be readily converted into cash.

Frequently, corporations promise their employees various forms of pensions. It is only fair that the funds which will be needed to meet these obligations shall be accumulated out of the employees' services, and the company, therefore, should from year to year reduce its surplus profits by a sum estimated to be necessary for this purpose. Such a reserve will likely

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[40] See C. W Gerstenberg, "Materials of Corporation Finance," page 624.

[41] Powder and chemical companies are apt to follow this practice. The General Chemical Co , a constituent of the Allied Chemical & Dye Corp., wrote $60,000 into its insurance fund in 1916 and $150,000 in 1917.

be called a "reserve for pensions." If a company engages in welfare work, as for example, building homes for employees, rest rooms, gymnasiums, and the like, such capital assets coming from profits can hardly be called producing assets and will therefore be offset by a reserve.[42]

Reserves for improvements necessitated by changed social conditions.—Certain types of business enterprise are forced to make expenditures at unexpected times because of changes representing social progress. Such a change, for example, would be a requirement that all overhead wires be buried underground. Usually, such changes do not result in an increase in the profits of the corporation. A reserve for such a contingency is in the nature of a reserve for depreciation due to obsolescence. For example, when the overhead wires are replaced by underground conduits, the new asset merely replaces the obsolete equipment.

Contingency reserves.—Many unforeseen situations arise in business that make it necessary for the company to have realizable assets readily available. For example, the corporation may face a period of low earnings caused by the invention of a new product which replaces one the corporation has been marketing, or by the invention of a new process, or by a change in the design of its product. During the adjustment period, when the company is making the necessary changes in its methods of production or reorganizing to permit the manufacture of the new product, it will need the protection of the contingency reserve to help it through the change. Similarly, the contingency reserve may aid the corporation through a difficult period occasioned by changes in consumer demand or by unexpected casualties. The contingency reserve may also be used to take advantage of unforeseen opportunities for increasing profits. The company that is in a position to act when it sees an opportunity to make profits, will advance more rapidly than one that does not pursue a policy of prep-

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[42] Perhaps the statement in the text would lead one to believe that the author did not appreciate the dollars-and-cents value of labor maintenance or welfare work We believe it pays best when it is unselfishly carried on and least is expected of it A teacher knows that gratitude blossoms only when there is no intention of gathering fruit A clipping, unfortunately undated, tells the story: "A special reserve was established in 1916–1917 for improving the working conditions of employees. It was one of the best investments the company ever made. As a result, American Car and Foundry has an organization that is second to none in business from the standpoint of efficiency."

aration for such opportunities through the creation of ample reserves.

Dividend equalization reserve.—We shall see later that a corporation gains much by paying a uniform rate of dividend year after year. Some companies, such as the American Car & Foundry Co., take out of the profits of good years certain sums which are labeled "reserve for dividends on common capital stock," the purpose of which is to keep in the company a sufficient amount of profits to equalize the dividends for the lean years.

American v. foreign reserve practice.—We have enumerated a number of forms of reserves. After all, they are fictitious entries on the liability side that serve to reduce the surplus. In foreign countries it is quite customary to break up the surplus in this way [43] In America the practice has been to let one general account—the surplus—stand for all these reserves [44] In other words, the corporation will always maintain a large surplus, the purpose of which is to accomplish the many objects for which foreign corporations set up separate reserves.

Arguments in favor of a large surplus.—The arguments in favor of a large surplus, given in the 1912 report of the president of the American Telephone & Telegraph Co. to the stockholders, show that in the American corporation the surplus is a sort of multiple reserve; the report contained the following statement:

> Among the more important advantages to a company of a large surplus represented in the fixed assets are the following.
>
> It strengthens the company's credit, enabling the company to make its interest and dividend payments uniform and dependable.
>
> It enables the company on the strength of this credit to obtain its capital requirements on the most favorable terms.
>
> It enables the company to ride out commercial and financial disturbances which might otherwise cripple or destroy it

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[43] For example, see C. W. Gerstenberg, "Materials of Corporation Finance," page 622

[44] However, exceptions to the general practice may be found. For example, the American Car & Foundry Co, in its report for 1938, carried in addition to a general surplus of $24,050,700, the following reserves.

For insurance	$1,500,000
For general overhauling, improvements, and maintenance	8,700,474
For employees	62,208
For dividends on common capital stock, to be paid when and as declared by board of directors	2,833,645

It enables the company to maintain at all times the highest state of efficiency in its operation, which would be impossible for any company which is obliged to adjust its more or less inflexible operating expenses to the constant and inevitable fluctuations of business

It is a reservoir, as it were, which, supplied by a fluctuating stream of gross revenue, enables the company to maintain even and uniform disbursement for service, maintain a uniform operating organization, and that high state of efficiency which can result only from a permanent operating force.

Another illustration of the same practice is furnished by the following remarks of the chairman of the United States Steel Corporation at a stockholders' meeting held on April 19, 1915; this statement was made in answer to questions propounded by stockholders of the company:

Assuming we have earnings for a certain year of one hundred and fifty millions of dollars, it requires to pay the interest on our bonds, our taxes—which have grown immensely, I am sorry to say, as all taxes have—to pay the dividend at the rate of seven per cent on the preferred stock, which you know is in advance of all dividends on the common stock and must be taken care of, and to put into our sinking fund or replacement funds a sufficient amount to keep our properties and to take care of the raw products that have been mined and smelted or burned, it requires something like seventy-five or eighty millions of dollars—I am giving all the time approximate figures Now, you see, that would leave seventy million dollars out of the one hundred and fifty millions. During the year it may be necessary, as it is every year, to make large expenditures for new properties. [The late Judge Gary explained that three plants had been built, one of which required the expenditure of $100,000,000, and added, "if we did not take care of our particular business others who were coming into it would take it away from us." For the same reason money was needed to substitute open-hearth furnaces for those required by the Bessemer process]

Then it was necessary for us to go into the manufacture of coke by the by-product system, at costly plants, where we not only get as good coke as we did by the old bee-hive oven process, but we save the by-products and eventually they will be very profitable. And just now, in war times, we are getting ready to produce by-products of very great value, very much needed for war purposes While we keep out of the war business, yet we sell to those in this country who need these products. And it has been necessary in many ways to spend large sums of money in taking care of your properties.

We have, by my illustration, seventy millions of dollars left from the earnings of the year. You can see that it may be necessary to expend in one year thirty or forty million dollars for these purposes And you may be certain that we do not expend anything that is not absolutely necessary. Now, suppose a lean year comes along, and we only make eighty or ninety million dollars, you see we have nothing left Now, then, when we make these expenditures we have the right to capitalize them and to issue bonds against them, and we have done that to some extent in the past, but largely,

as you know, we have paid out of the surplus earnings the cost of these very great extensions and improvements so as to avoid increasing our fixed charges. Now, in doing this we have charged to capital a part only of the expenditures, and the other part we have charged to cost of operation.

To the extent that we have decided to charge to capitalization and leave these expenditures in the position where we could issue securities against them if we desired to do so, to that extent, of course, there is a surplus. But it is not a surplus in cash, it is in property. And, being in property, it is not available for distribution in dividends, as you can see. So that our surplus which we report from time to time is not only legitimately, but conservatively, stated We have not kept any more cash on hand than has been necessary to run our business We need, when business is good, about seventy-five million dollars in cash And we aim to keep about that amount on hand.

Sources of surplus.—We may summarize our discussion of dividend policies up to this point dividends, from a legal viewpoint, are payable out of excess of assets over liabilities; but we must be sure that the excess of assets is real, and to get this assurance we must see if proper reserves have been separately set up or whether, if the reserves are included in the general surplus, a reduction of that surplus by the amount of the proposed dividend would in effect impair those reserves.

We now come to the second step in the scientific analysis of dividend policy. We must see how the excess of assets was built up. The sources from which a company may earn and accumulate profits must be understood before one attempts to formulate any rules as to what disposition should be made of these profits. These sources may be briefly summarized as follows:

1. Earnings from regular operations. Ordinarily this is *the* source of profits.
2. Earnings from outside operations.
3. Income from securities of subsidiaries.
4. Sale of assets at an amount in excess of their cost or book value.
5. Revaluation of assets.
6. Sale of securities at a premium.
7. Paid-in surplus.
8. Reduction of capital stock or capital.
9. Conversion of unnecessary reserves into surplus.
10. Donated surplus.
11. Surplus derived from constituents of consolidation.
12. Surplus accumulated from earnings of previous years.

We shall now examine each of these sources separately and see if, from the standpoint of financial expediency, surplus built up from each source is available under any circumstances for dividends. Incidentally, we shall refer to some legal problems arising from the nature of the source of surplus.[45]

Earnings from operations.—Other conditions being favorable, a surplus built up from this source should be distributed as dividends. A company exists primarily for its stockholders and they have a right to receive the earnings made from operations.

Income from subsidiaries.—As subsidiaries make profits and their surpluses swell, dividends may be paid to the parent and the parent may in turn use them for dividends to its own stockholders. Of course, subsidiaries should not be "skinned" to enable the parent company to make a good showing. On the other hand, subsidiaries should not be permitted to accumulate large surpluses which, when turned over suddenly to the parent, enormously enhance the value of the latter's stock. Such a procedure would easily result in manipulation.[45a]

Sales of appreciated property.—The general principles governing the determination of "what is income," disclosed by rulings of the courts and of the Treasury Department under the Federal Income Tax Law, are to the effect that increases in the value of capital assets are not true income until they are "realized" through sale of the assets. Some authorities would have it that increases in the value of assets, even when realized through sale, should not be taken as the basis of dividends.[46] The true principle, it would seem, is that profits from the sale of unnecessary property may be used for dividends, whereas the proceeds of property sold to be reinvested in similar property, even to the extent of the profits realized through the sale, should not be used for dividends. The reason is that the new assets take the place of the old assets and the sale therefore does not actually "realize" the profits.

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[45] The Securities and Exchange Commission has ruled that registered public utility holding companies and their subsidiaries shall not pay any dividends out of capital or unearned surplus, and has provided a uniform system of accounts for such companies Therefore many of the principles mentioned below may not be applicable to companies subject to the Public Utility Holding Company Act of 1935

[45a] See, for example, Harriman's policy, W Z Ripley, "Railroads, Finance and Organization," page 515

[46] See A. S Dewing, "Corporate Promotions and Reorganizations," pages 178–9, footnote 8

Revaluation of assets.—On the principle that "whatever goes up may come down," a profit indicated on the books of a company through a process of revaluing assets ought not to be made the basis of a dividend unless the dividend is called for by very special circumstances.[47] Where, for example, cumulative preferred stock is much in arrears, and an honest revaluation will show a surplus that could clean up the arrearages, the surplus may be created in this way and a stock dividend may be paid provided the present and prospective earnings are and will be ample to maintain dividends at a reasonable rate on the new capitalization.[48]

The tendency of corporations to increase their reserves and to invest amounts representing reserves in marketable securities, as well as the widespread development of investment trusts, has made the question of revaluation of securities extremely important. The surplus of an investment trust is derived principally from dividends and interest on securities owned, and from profits made in the sale or exchange of securities. Suppose that the securities owned have risen tremendously in value, as they did from 1925 to 1929, and that the securities have not been sold—may the investment trust declare dividends from a surplus created by revaluing the securities on the basis of their market value? And when a drop in market prices occurs, such as happened from 1929 to 1932, must a revaluation of the securities be made on the

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[47] The danger of paying dividends out of revaluations is shown by the following resolution of the board of directors of the Cities Service Co, adopted in the autumn of 1916, intended, no doubt, to give confidence to prospective purchasers of securities as well as to present security holders.

That until such time as there has been invested in the property of the Cities Service Co, or its subsidiaries, from the earnings of the company, a sum equal to the entire par value of the preferred stock then outstanding, there shall be no dividends paid in cash on the common stock in excess of 6 per cent per annum, unless the company shall, for a period of six months, have purchased and retired all preferred stock that can be purchased in the open market at 110 per cent or par or less That until the foregoing has been complied with, no surplus or portion of surplus created by an increase due to the revaluation of assets, already carried on the books, may be used as a basis for the distribution of cash dividends on the common stock.

[48] See, for example, A S Dewing, "Corporate Promotions and Reorganizations," Chap. I. For a brief discussion of the law, see *ante*, page 560 Many companies revalued their properties in their balance sheets at the beginning of the period of high taxes to get the benefit of high invested capital under the excess profits tax, and the benefit of adequate allowances for depreciation and depletion under the income tax For example, a clipping from the *Boston News Bureau*, of May 23, 1918, stated that the New India Quicksilver Mining Co. had "marked up property valuation from practically nothing to $3,689,700 in order to have a more equitable basis from which to figure taxes and ore depletion."

basis of current market value, and must the surplus be diminished accordingly? The matter of paying dividends out of a surplus created by unrealized appreciation of securities is left entirely to the discretion of the directors in cases where the statute does not require that dividends be paid out of earnings. In practice, many investment trusts have declared dividends out of surplus thus created. As to the second question, court decisions are not helpful in arriving at a solution. In general, a marking down in the value of securities should be made if the decline in their value is attributable to an actual decline in their investment merits.

Sale of securities at a premium.—If a share of stock that has a par value of $100 is sold at $125, the premium of $25 might be reflected in the surplus. And the same thing is true of a bond sold at a premium. May and should a premium, and an increase in the surplus thus created, be made the basis of a dividend? The answer is, dividends *may* be paid from these sources if the transaction does not amount to fraud,[49] but they should not be paid from these sources unless the stockholders and bondholders knew before they paid for their securities that a part of their money would be used for dividends. When people put money into a corporation, they expect their investment to be used for the production of operating profits. Even the bondholders expect that the strength of their security will be maintained by an investment of all their funds in useful projects.

On the other hand, a corporation may say to prospective stockholders, "In order to start dividends immediately, we will charge you a premium on your stock and will use the premium as far as is necessary for dividends in the early years."

But if, after a premium has been charged to purchasers of stock, dividends are paid out of the premium, and then the corporation advertises in connection with the further sale of its stock that "dividends have been paid at — per cent," without revealing the source of the dividends, the prospective purchaser would undoubtedly be justified in believing that the

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[49] A. Machen, "Modern Law of Corporations," Sec. 1334 and cases there cited The Interstate Commerce Commission prevents payment of dividends out of premiums on the sale of securities by providing special accounts for them. See H. Adams, "American Railway Accounting," pages 177–8 and 448–9 See also footnote 45.

dividends were paid out of the earnings of operations. If he parted with his money on that assumption and later the company failed, he would probably have a good cause for action on account of misrepresentation.

Dividends from paid-in surplus.—The statutes which permit the directors to allocate a portion of the consideration received for non-par stock to capital and the balance to paid-in surplus, make it legal for them to turn back to the stockholders, in the form of dividends, a part of the price paid for the stock.[50] The purpose of permitting part of the purchase price to be thus distributed is to enable the corporation, which has raised new capital on its promise to pay dividends, to do so during the period that must elapse before dividends can be paid out of earned income. The payment of dividends before earnings warrant them—though there is always the danger that the surplus may be exhausted before earnings are realized—may help the credit of the company. Certainly it aids the corporation in selling its securities, and, incidentally, the investment bankers in marketing new issues of stock. Laws permitting the payment of dividends out of surplus created in this way have been subject to criticism on the ground that in the hands of unscrupulous managers the law is subject to abuse.[51] The use of paid-in surplus for dividends is more easily justified for preferred stock than for common stock.

The creation of paid-in surplus is not confined to allocation in the case of non-par shares. For example, upon the issuance of additional stock by a corporation which has an earned surplus, the price may be fixed at a figure that enables a ratable part of the consideration, equal to the amount of the earned surplus applicable to each share theretofore outstanding, to be regarded as paid-in surplus. This has the effect of keeping the surplus which is available for dividends,

[50] Paid-in surplus originating through contributions to surplus at the beginning of business was little known before non-par stock came into use Formerly, such paid-in surplus was found principally in the balance sheets of banking, insurance, and trust companies, which received paid-in surplus to strengthen their credit, or to reduce the double liability to which stockholders of banks are usually liable. It was also occasionally created in the case of corporations which issued two classes of stock, the common paying more than par value in order to create a surplus out of which dividends on the preferred could be paid during the first years of operation

[51] See A. A. Berle, "Investors and the Revised Delaware Corporation Law," *Columbia Law Review*, May, 1929.

proportionately the same after the additional shares are issued as it was before the increase. For example, suppose a corporation has capital stock of $100 a share and an earned surplus equivalent to $50 a share. Upon an increase in the stock, the price may be fixed at $150 a share, $100 to be regarded as capital and $50 as paid-in surplus. Paid-in surplus created in this way may be treated as earned surplus and the principles governing distributions of dividends from earnings would be applied in its distribution.

Reorganizations of corporations which have a surplus at the time of the change in organization may result in the creation of a paid-in surplus. For example, if corporations *A* and *B*, each having an earned surplus, form corporation *C*, the new corporation will begin with a paid-in surplus equal to the combined surpluses of *A* and *B*. The distribution of dividends from such surplus is discussed on page 597.

Surplus from reduction of capital stock.—Paid-in surplus may originate from an authorized reduction in capital stock or in the capital represented by non-par shares. The reduction, of course, must be made according to statute and only if the rights of the various classes are preserved. The advisability of paying dividends from such a source is questionable, since in effect a distribution of this kind is a return of capital.[52] The laws of the State in which the corporation is organized may make it illegal for a corporation to pay dividends from surplus thus created. For example, if the statute requires that dividends be paid out of net earnings or profits, a dividend from this source would be illegal. In at least one State, Ohio, the corporation must inform the stockholders of the source of the surplus from which dividends are paid if the payment is not out of earnings. Such a procedure is advisable even when not required by law.

Converted unnecessary reserves.—We have seen that reserves are in effect "ear-marked" parts of the surplus. If the company accumulates a reserve much beyond the require-

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[52] Many corporations resorted to this method of creating surplus out of which to continue to pay dividends when the reduced earnings of 1930 and the following lean years made dividend payments out of current earnings impossible The procedure was justified in the case of the investment trusts on the ground that the holders of the trust certificates were really looking to the income from the pledged securities for their dividends; they were entitled to the income, so the argument ran, in spite of whatever might have become of the market value of the collateral.

ments for which it is established, it may turn part of the reserve back into the surplus account and use the amount for the payment of dividends. Thus, if a reserve for depreciation was set up for an asset that was assumed to have a life of ten years, an original value of $1,000, and a residual value of $200, the company might use the straight line method and set aside from earnings each year $80 If after fifteen years the asset was found still to be in use and giving satisfactory operating efficiency, the reserve would amount to $1,200, $400 of which would be excessive. The reserve could then be written down to $800 and the surplus increased by $400. It would seem fair under such circumstances to call the attention of the stockholders to the change that had been made and to leave the amount in the surplus for some time before using it for dividends; otherwise the directors might subject themselves to the suspicion of manipulation.

Secret reserves.—Somewhat akin to the subject of unnecessarily large reserves is that of secret reserves, which may be mentioned here in passing. A secret reserve is one that is built up through charging capital expenditures to the revenue account. For example, if a railroad company substitutes a crushed-stone ballast for cinder ballast, the investment in road and structures appearing as an asset in the balance sheet should be increased by the difference between the cost of the more expensive stone ballast and the original cost of the cinder ballast. If this were done, the surplus would be proportionately increased. However, the whole of this cost—before the days of uniform accounting—might be charged to operating expenses and not revealed as an asset at all. To the extent that the asset should have been increased but was not increased, there exists a secret reserve. If, now, at a subsequent period this asset is written into the balance sheet and the surplus is proportionately increased and dividends are also proportionately increased, the directors might make considerable private profit out of the unexpected melon. This they could do by buying the stock from ignorant stockholders who do not know of the secret reserves.

Donated surplus.—Frequently, stock will be issued to a promoter for an asset of uncertain value, such as a mine, a patent, or goodwill, and the promoter will return part of the stock to the company to enable it to sell the stock below par.[53]

[53] See *ante*, page 132.

If, for example, a mine is transferred for $1,000,000 of stock and then $500,000 of the stock is returned to the company, its balance sheet will appear as follows:

Mine	$1,000,000	Capital Stock	$1,000,000
Treasury Stock	500,000	Surplus	500,000

Can the company pay dividends out of this surplus? The same general principles apply here as were explained in connection with dividends paid out of premiums, (see page 593). If the promoter in this case sold $50,000 of the treasury stock "at 50," and incurred an expense of $5,000 in so doing, the balance sheet would read

Mine	$1,000,000	Capital Stock	$1,000,000
Treasury Stock	450,000	Surplus	470,000
Cash	20,000		

Suppose, now, that he uses the $20,000 to pay a dividend of 2 per cent and that he advertises the remainder of the treasury stock for sale, stating that "an initial dividend of 2 per cent has been paid on this stock." He has made two mistakes—to use a euphonious word: first, he has misappropriated part of the money invested by the people who bought the first $50,000 of stock; they committed their money to him on the implied understanding that the money would be used for the ordinary expenses of the company and for purchasing machinery with which to work the mines. In the second place, the new stockholders—those he is trying to induce to come into the company on the basis of the dividend—have the right to assume that the dividend was paid from the proceeds of operations. It will be seen, therefore, that dividends from this source should not be used without a full understanding by all parties concerned.

Surplus derived from the constituents of consolidation.—Where corporations *A* and *B* consolidate to form company *X*, the balance sheet of *X* will likely reflect in its surplus item the combined surpluses of *A* and *B*. Before *X* pays dividends, its directors should examine the sources of *A*'s and *B*'s surpluses and apply to them the rules stated above as to the expediency of paying dividends from the various sources.

Surplus accumulated from earnings of previous years.—We saw how American companies build up large surpluses which act as dividend equalization reserves. Dividends are paid from such a surplus under two circumstances: (1) in lean

years when the regular rate cannot be maintained out of current earnings,[54] and (2) as a "melon" or extra dividend, when the surplus becomes too large and the directors believe too large a part of the profits has been undistributed.

From the standpoint of the Federal income tax, a corporation that was in existence before March 1, 1913, should keep a careful historical record of the condition of its surplus, since income taxes cannot be levied, pursuant to the constitutional amendment that went into effect February 28, 1913, on income earned before March 1, 1913, though the general rule is that every dividend is presumed to be paid from the most recently earned income.

Assume that a corporation had a surplus of $100,000 on March 1, 1913, and sustained a net loss of $50,000 for the period from that date to December 31, 1922, although having earnings of $10,000 for the year 1922 If it paid a dividend of $50,000 in 1923, at which time it had earnings of $30,000 for that year, only $10,000 of the dividend could be treated as having been paid from surplus on March 1, 1913 [and this amount would be tax-free in the hands of the stockholders] [55]

A definite dividend policy.—We have seen that the first two steps in the solution of the problem of whether or not a dividend should be declared, are. (1) an examination of the company to ascertain if a dividend legally can be declared, and (2) an examination of the sources of the surplus to see if the dividend can be declared from the standpoint of expediency. Certain other questions may arise: (1) is the cash position of the company such as to justify a distribution of cash at the present time; (2) what are the future prospects of the business itself, and of the general economic situation of the country? If, for example, the company is expanding rapidly and needs plenty of cash, which on account of external conditions can be raised only at a high premium, the corporation may be justified in withholding a cash dividend. (3) If a cash dividend cannot be paid and some distribution should be made to satisfy the equities between present and future owners, the

[54] An interesting study of dividend policies during the depression, based upon reports of 348 corporations, indicated that the number of corporations which dipped into their surplus to pay dividends during the business cycle 1929–1935 increased rapidly in 1930, reached a peak in 1931, declined a bit in 1932, and then fell off sharply See R L. Tebeau, "Dividend Policies During the Depression," *Dun's Review*, April, 1938

[55] The Supreme Court of the United States has held that a surplus accumulated prior to March 1, 1913, is reduced by subsequent operating losses. Helvering v. Canfield, (1934) 54 S. Ct 368

choice lies between a stock dividend and a scrip dividend. Let us suppose, for example, that *T* holds a number of shares of stock in trust for *L* for life, remainder to *R*. We may assume that the corporation needs all the funds that it can get hold of and therefore does nothing in respect to dividends. However, the assets into which the earnings are ploughed increase in value and the surplus expands proportionately. We may assume that the book value of the stock in question was equal to par at the time *T* became the owner, and that the surplus expands during a period of ten years, bringing the book value of the stock up to $300 a share. Still nothing is done about the dividend. *L* dies, leaving a will in which *A* and *B* are given all his property. Immediately thereafter the company pays a 200 per cent dividend in scrip. If that scrip dividend had been paid just before *L*'s death, it would all belong to *A* and *B*. Morally, they should get the scrip, since the earnings were accumulated during the life of *L* and the general intent of the person creating the estate was that all the earnings on the stock should go to the life tenant, *L*. Since the company delayed the dividend till after *L's* death, however, the dividend would go to *R*.[56] From this point of view it therefore behooves a company to pay out its earnings regularly and if they cannot be paid in cash they ought to be paid in the form of scrip. We have already pointed out that a stock dividend should not be declared unless the prospects

[56] The rule known as the Pennsylvania rule provides that dividends declared during the life of a life tenant shall go to the life tenant to the extent that they were earned during the existence of the trust, the rule is followed not only in Pennsylvania, but in California, Iowa, Minnesota, Mississippi, New Hampshire, New Jersey, South Carolina, Tennessee, Vermont, and Wisconsin Under the Massachusetts rule, followed as well by the United States courts and by the courts of Connecticut, Georgia, Illinois, Indiana, Maine, Michigan, Missouri, Nebraska, Ohio, Rhode Island, and West Virginia, cash dividends (and probably scrip dividends) go to the life tenant, while stock dividends go to the remainderman In New York, until May 17, 1926, the practice was similar to the Pennsylvania rule, giving extraordinary cash dividends to the life tenant unless they intrenched upon the capital of the trust fund, in which event the extraordinary cash dividends were apportioned between life tenant and remainderman so as to preserve the intact value of the trust fund For trust funds created after May 17, 1926, the rule is that stock dividends belong to the remainderman; no change was made regarding ordinary and extraordinary cash dividends. The following States, having adopted the Uniform Principal and Income Act, follow the Massachusetts rule. Florida, Louisiana, Maryland, North Carolina, Oregon, and Virginia The facts in the problem lead to the conclusion that under either rule, the dividend having been declared after the termination of the trust, the dividend would go to *R*.

for future earnings are sufficiently bright to warrant the expectation that they will yield a fair rate of dividend on the increased amount of stock that will be outstanding after the dividend is distributed. But this brings us to the next step in dividend policy.

(4) Where earnings are unusually large, a stock dividend may be used as a step in the readjustment of the capitalization. If, for example, the company is earning at the rate of 40 per cent on its outstanding stock, it may very well declare a stock dividend in order to reduce the apparent rate of earnings down to 20 or even 10 per cent. Unless the corporation has been accumulating its surplus for a number of years, it will have to write into the asset side some item such as goodwill in order to build up a sufficiently large surplus to justify the 100 or 200 per cent dividend that will be needed. However, goodwill appraised at a fairly high figure could easily be predicated upon earnings at the rate of 40 per cent.

Unless the apparent rate of earnings is brought down by a stock dividend, the company will encourage competition, will incur the displeasure of customers who will feel that they are paying too much for the company's product, and may invite some form of government action on the basis of alleged monopoly or on the basis of general public interest.

(5) A dividend may be necessary to protect the interests of old stockholders when a company is about to sell a new issue of stock. A concrete example will make the principle clear. A corporation was organized by several persons who from time to time added investments to the business and drew no dividends. Earnings were "ploughed into the business" till the time arrived when it was necessary to get a considerable amount of new capital from outside sources. At that time the surplus exceeded the amount of capital stock outstanding; the capital stock, therefore, was worth considerably more than par. To get investors to pay more than par for their stock was known to be extremely difficult; if stock were sold to them at par, part of the surplus of the company would have been presented to them gratuitously. To escape this difficulty a stock dividend was declared before the new stock was offered to outsiders, thus transferring the sole ownership of the surplus to the old stockholders.

In establishing a definite dividend policy, which usually involves the adoption of a fixed regular dividend rate, the

directors must be guided by facts revealed in a study of the financial history of the company. The size of the surplus, the amount of fluctuations in earnings in past periods, the average earnings over the past five or ten years, and the frequency of periods resulting in operating deficits, as well as a consideration of the factors mentioned above, will form the basis of the directors' decision. Conservatism in the payment of dividends makes for accumulation of surplus that may eventually lead to the establishment of a higher rate and greater regularity of payments.

Advantages of stable dividends.—The final aim of a corporation should be the declaration of dividends at a fairly stable rate year in and year out. Stockholders, of course, have the right to expect that as prices of all commodities and services increase, their income also will increase. A stable dividend policy, therefore, does not mean an inflexible policy, but one that involves the payment of a fair rate of return, taking into consideration the gradual growth of the business and the gradual evolution of external events.

A stable dividend record improves the credit of the company and increases the value of the company's stock. For example, for the ten years beginning with 1913, United States Steel paid annual dividends on the common stock as follows: 1913—5 per cent, 1914—3 per cent, 1915—1¼ per cent, 1916—8¾ per cent, 1917—18 per cent, 1918—14 per cent, 1919—5 per cent, 1920—5 per cent, 1921—5 per cent, 1922—5 per cent. The ten-year average was 7 per cent. During the same time the National Biscuit Company paid 7 per cent annually. The average price of United States Steel common during that period was 85.5, whereas the average price of the National Biscuit Company stock was 115½.

A similar comparison for the period 1922–1939 is not readily found. A survey of dividend records during that period shows a marked degree of irregularity even among corporations that in previous years had maintained a regular rate. The change indicates not an abandonment of the principle that a stable dividend record is advantageous to the corporation, but a tendency toward adjustments in capital structures resulting from the expansion of business units in the first part of the period mentioned and from operations at a loss during the depression period. Thus in the period mentioned, many corporations increased their capitalizations, giving stockholders the right to subscribe to new issues of

stock at prices below the book value of the stock,[57] others changed from par value to non-par value shares; still others lost their identity in mergers with larger corporations or grew in size by the consolidation movement, and many split up their shares, giving old shareholders anywhere from two to five new shares for each original share. Following the depression period, many recapitalizations occurred to remove accumulated preferred dividends Changes such as these frequently affect the dividend rate and make comparison with earlier years difficult.

Attention should here be called to the fact that even in the case of cumulative dividends, arrearages are not made up with interest. A dividend skipped is like milk that is spilt. Small dividends, therefore, are preferable to no dividends.[58]

The bonds of railroads, and in some States, of public utilities, may become what are known as legal investments or "legals" by maintaining a minimum dividend on all their stock. By this is meant that trustees and financial institutions such as savings banks and insurance companies may invest their funds in these securities; if other securities are purchased, the trustees or directors become personally liable for any loss that may be involved in a decrease in the value of

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[57] See page 344 for a discussion of the value of rights and their relation to dividends.

[58] The author likes to call the attention of students to the fact that the first fifteen years of interest on a 5 per cent bond is today worth all the rest of the bond-interest and principal. The reader can verify that for himself by reference to a present-worth table on page 1024, Column B, of C W. Gerstenberg, "Materials of Corporation Finance." If the reader will add the present worth of $1 00 for the first fifteen periods and multiply by 50 (each interest payment on a 5 per cent bond is $50) he will find the present worth of the first fifteen coupons to be about $519 If we assume that the principal is to be paid at the end of fifteen years, the present worth of $1.00 is shown to be $ 481 and therefore the present worth of $1,000 will be $481, making the total present worth of the fifteen years and the principal exactly $1,000 The reader will also notice that if the payment of the principal is postponed one year (that is, if the bond becomes a sixteen-year bond) the present worth of the principal decreases by about $23 However, another interest payment of $50 will be due, the present worth of which will also be about $23, and so year after year, as the principal is postponed—that is, as the term of the bond is lengthened—the present worth of the principal will shrink by an amount equivalent to the present worth of the extra interest payment Therefore, no matter how long the bond is extended, no matter how many coupons are attached to the bond, all of the coupons except the first fifteen added to the principal are worth today less than $500. If, therefore, a promoter were to say to you, "I will sell you these ten shares of stock, par value $100, for $1,000, but the company is not likely to pay dividends for the first fifteen years, after which it is sure to pay 5 per cent," he practically makes a proposal to you to take one-half of your money. Surely a bird in the hand is worth two in the bush.

the securities. Since funds from trustees and financial institutions make up a very large part of the investment credit of the country,[59] it behooves a railroad or utility to conserve its resources in such a way that dividends will be paid out of accumulated surplus even when not earned currently. Since in some cases to become eligible the bonds must be those of a company with an unbroken dividend record of five years, one break in the record may disqualify the securities for a period of five years.[60]

The income tax regulations provide that a taxable distribution made by a corporation to its shareholders or members shall be included in the gross income of the distributees as of the date when the cash or other property is unqualifiedly made subject to their demands. It will be noticed that the tax is incurred in the year in which the dividends are distributed, not in the year in which they are earned by the corporation. Every reader of this book probably has had enough experience with the income tax to know that the rates are graduated; that the larger the dividend the higher the rates. Hence a corporation should not accumulate its profits and then distribute them in one year, thus making them subject to higher rates in the hands of its stockholders than if they were distributed evenly, year after year.[61] For example, in 1918 a statement was made in the financial press that the directors of the Atlantic, Gulf and West Indies Steamship Lines "have no thought of paying an extra dividend . . . The point is that control of A. G. W. I. is not in the open market. The directors themselves own control and the last thing that directors want at this stage is a big dividend, 50 per cent or

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[59] In 1917, when the net earnings of the Boston Elevated Company dropped on account of mounting costs, the statement was made that over half of its $26,586,000 of bonds were held by the savings banks of Massachusetts

[60] See footnote, p 355 Sometimes the legal status of a security depends on whether the company has "earned and paid" the dividend, and in other cases on whether the dividend has been paid regularly In the former case accumulated surplus will not affect the legal status

[61] If the corporation should attempt to remedy the mistake of having withheld dividends by declaring a stock dividend in special stock to be redeemed gradually, the stock dividend would probably be taxable. (See page 570); Even if it were not, the result would probably be that the full amount received upon the redemption of the stock would be subject to Federal income tax as a dividend in the hands of the stockholder. See Art. 115–9, Reg. 101

60 per cent of which they would immediately have to pay back to the Government in taxes."[62]

Some statistics relating to dividend policies.—The following statistical material, though old,[63] may prove interesting

TABLE No 10

COMPANIES WHOSE EARNINGS FLUCTUATE WIDELY, AND THEIR DIVIDEND RECORDS

	Average net earnings 10 years	*% of maximum deviation from average net earnings*	*% of average deviation from average net earnings*	*% distributed as dividends*	*% retained as surplus*
MANUFACTURING:					
Steel, etc :					
Bethlehem Steel Corp	$15,753,277	178.0	53.0	30.0	70.0
Republic Iron & Steel Co	5,279,377	196.0	93.0	46.5	52.5
Motors					
Packard Motor Car Co	3,671,670	194.0	70.0	35.0	65.0
Pierce-Arrow Motor Car Co	988,670	1000.0	299.0	100.0[b]	0.0
Rubber, tires, etc					
U. S Rubber Co	11,056,355	95.5	45.8	57.4	42.6
B. F. Goodrich Co	6,375,749	405.0	115.0	58.6	41.4
Textiles and leather:					
American Woolen Co	5,514,056	122.0	52.2	72.5[c]	27.5
Central Leather Co	3,878,712	680.0	210.0	114.0[d]	−14.0
Foods, etc :					
American Sugar Ref Co.	7,097,563	86.0	55.0	92.3	8.7
United Fruit Co	12,361,133	134.0	50.5	38.0	62.0
Miscellaneous and Specialties					
American Can Co	5,982,308	100.0	28.2	47.5	52.5
E I du Pont de Nemours	35,264,641[a]	134.0	70.0	70.6	29.4
TRADING (Mail Order)					
Sears Roebuck & Co .	9,880,877	266.0	59.8	53.5	46.5

[a] Six years, 1916–1921

[b] During the five years prior to 1921, Pierce-Arrow had reserved 78% of earnings In 1921 a net loss of $8,763,712, including over $4,000,000 inventory adjustment, wiped out their entire surplus, causing a balance sheet deficit in excess of $4,000,000

[c] This company has outstanding $10,000,000 7% preferred and $40,000,000 common The large proportion of preferred required relatively large dividend disbursements

[d] From 1912 to 1919 Central Leather had retained over $37,000,000 out of net earnings of $72,000,000, or 48.5% Due to the heavy losses in 1920 and 1921, the entire accumulated surplus for over eight years was wiped out, causing a balance sheet deficit of $6,893,818

[62] *Boston News Bureau*, February 4, 1918.

[63] Studies based on dividend records for the years given in these tables illustrate the points made in this chapter perhaps better than would studies based on more recent dividend records, on account of the influence of the conditions outlined on page 601.

in connection with some of the principles already stated; it is doubtful, however, if information of this kind has much value, since in every case surrounding circumstances, such as the historical growth of companies, the form of the financial

TABLE No. 11

COMPANIES WITH RELATIVELY STABLE EARNINGS, AND THEIR DIVIDEND RECORDS

	Average net earnings 10 years	*% of maximum deviation from average net earnings*	*% of average deviation from average net earnings*	*% of net earnings paid as dividends*	*% of net earnings carried to surplus*
American Radiator Co	$2,640,425	35	17.6	90.6	9.4
Bush Terminal Co	690,468	65	31.8	58.0	42.0
American Snuff Co	1,782,794	17	8.0	86.9	13.1
Diamond Match Co	1,815,512	45	24.0	70.5	29.5
General Cigar Co	1,851,486	85	28.2	66.7	33.3
Liggett & Myers Tob. Co.	7,156,200	38	12.6	62.8	37.2
Mergenthaler Lino. Co	2,105,357	36	21.4	75.0	25.0
P Lorillard Co	4,885,816	34	20.4	67.6	32.4
National Biscuit Co	4,967,952	24	11.5	76.0	24.0
National Lead Co	3,555,441	35	28.0	74.0	26.0
Standard Milling Co	1,427,261	60	32.4	50.6	49.4
United Shoe Mach. Corp	5,452,583	72	25.5	75.4	24.6
S. S. Kresge Co	1,760,091	93	37.5	29.0	71.0
F W. Woolworth Co .	8,483,730	62	22.3	53.4	56.6

TABLE No. 12

DIVIDEND RECORDS OF IMPORTANT INDUSTRIALS ESTABLISHED TWENTY YEARS OR MORE

	Consecutive years of dividends to Jan 1, 1922	*Average dividends %*
American Sugar Refining Co	31	8.72
Diamond Match Co	32	9.93
General Electric Co	21	8.55[a]
Mergenthaler Linotype Co	27	14.30
National Biscuit Co	23	5.76
Pullman Company.	46	8.57[b]
Swift & Company . .	34	7.91
United Fruit Co . . .	23	9.43
Westinghouse Air Brake Co	46	30.30[c]

[a] Also 116⅔% in stock

[b] Also 106% in stock

[c] Also stock dividends amounting to 73⅓%

plan, conditions in the industry, tax burdens, and the like questions, have great influence in the policy followed.[64]

TABLE No 13

PERCENTAGE OF NET EARNINGS DISTRIBUTED BY ENGLISH AND AMERICAN COMPANIES[65]

Year	*Preferred* Amer. %	Eng %	*Common* Amer %	Eng %	*Surplus* Amer %	Eng %
1912	25 5	23 6	29 0	48 3	45 5	28 1
1913	28 8	22 3	34 4	50 5	36 8	27 2
1914	31 5	24 4	37 7	62 0	30 8	13 6
1915	21 2	20 5	29 2	63 0	39 6	16 5
1916	11 9	23 9	29 8	47 8	58 3	28.3
1917	13 4	21 2	31 2	51.8	55 4	27 0
1918	14 2	20 6	32 0	48 0	52 8	31.4
1919	15 9	16 8	33.1	46 5	51 0	36 7
1920	19 5	19 3	56 2	56 2	34 3	34 5
1921	55 6	26 8	12 0	65 8	−75 6[a]	7 4
Ten year average	18 6	22 5	36 8	51 5	44 6	26 0

[a] If Sears Roebuck & Co is omitted, the percentage is approximately −61 0

[64] These tables are taken from an unpublished thesis written under the direction of the author by Harold Taylor Gates, M.B A , in partial fulfillment of the requirements for the degree of Master of Business Administration at New York University (1923). Mr Gates says in his conclusion, "Investigation of the policies pursued by the various types of corporations—those whose earnings are stable and those whose earnings fluctuate—has indicated the futility of attempting to apply any 'average' practice to certain types or to particular corporations "

[65] The comparison for the ten years shown above reflects practices better than would a table constructed for the following decade, for during the latter period many American companies increased their capitalizations and actually ploughed the surplus into the company through that process.

For the years 1928, 1929, and 1930 the percentages are as follows:

	Preferred Amer. %	Eng %	*Common* Amer %	Eng %	*Surplus* Amer. %	Eng. %
1928	12 1	18 8	55 4	58 9	32 5	22 3
1929	10 7	19 8	52 7	61 2	36 6	19·0
1930	15 1	21 9	72 0	60 2	12 9	17 9

The percentages for the American companies are based upon annual financial statements of companies that may or may not have been included in the original compilation.

The American practice increases the productive capacity of the country, when consumption is also increased, the tendency of the practice is to defeat its own purpose through a reduction of the capital values of the industries of the country. Compare Foster and Catchings, "Profits," p. 399.

Chapter XXVIII

INTERCORPORATE RELATIONS

Forms of intercorporate relations.—We have seen in previous chapters how business enterprises are formed by natural persons. We are now to consider forms of business organization in which corporations instead of natural persons are the constituents. The principal forms of intercorporate relations are the informal agreement, the pool, the trust, the community of interest, consolidation, sale of assets, lease of assets, and holding company, each of which we may define briefly as follows:

An *informal agreement* is an oral arrangement through which the persons in control of several corporations agree to conduct their respective businesses in a certain way. The arrangement usually has the same objects in view as the pool.

A *pool* is a more formal agreement, usually, though not necessarily, in writing, by which corporations or the persons who control them, without surrendering full control—as they do in the case of consolidation, sale or lease of assets—seek to bind one another to conduct their respective businesses in a way to achieve some common end. This common end may be the maintenance of prices, the division of the market, or the limitation of redundant output; the exact nature of the devices that may be used varies widely.[1] The patent pool has been used frequently to defeat the purposes of the anti-trust laws.[2]

A *trust* is a combination of business units through the creation of a voting trust to control the voting stock of several corporations.[3]

A *community of interest* is any form of intercorporate relations in which the legal relationships of the corporations

[1] See W. S. Stevens, "Industrial Combinations and Trusts."

[2] See "The Relation of Patents to Industrial Monopolies," by Floyd L. Vaughan, in the *Annals of the American Academy of Political and Social Science*, Vol. 147, p. 40 (1930).

[3] See page 117.

or of their stockholders are not clearly defined, as, for example, where several persons related in some business enterprise together, but in their individual names, control the stock of several otherwise unrelated corporations.

A *consolidation* is in effect the incorporation of several corporations into one. It is a complete legal fusion carried out according to the terms of a statute.

Sale of assets, as its name implies, is a process by which corporations are brought together through a sale of all the assets of one company, or of a department of one company, to another company.

Lease of assets is that form of intercorporate relations which takes place when one corporation is given complete control over another through a lease of all the latter's assets.

A *holding company* brings corporations into intercorporate relations by controlling their directors through stock ownership.

Other forms of intercorporate relations are found in the trade association, the formation of groups for purposes of advertising in common, the organization of groups for co-operative buying, agricultural co-operatives, export associations, and other types of combinations based principally upon contractual relations. In this book we shall consider only intercorporate relations which affect the corporate structure of companies entering into the combination, and hence we shall omit any discussion of intercorporate relations brought about through associations such as those just mentioned.

Before considering in detail the various methods of combination coming within the scope of this book, let us briefly run over the history of intercorporate relations in this country and the economic grounds on which intercorporate relations are based.

History of intercorporate relations, showing changes in methods.—Corporations consolidated before the Civil War. Thus in 1853 the New York Central was formed as a consolidation of the short lines between the Hudson River and Buffalo in the State of New York. Though this was the first consolidation of real importance in the railroad field, other consolidations had been effected even previous to this; the Philadelphia, Wilmington and Baltimore, for example,

was organized as early as 1838 as a consolidation of three other companies.[4]

In the industrial field the movement toward intercorporate relations dates back to about 1861, when a trade agreement was consummated among cordage manufacturers "to establish certain customs in the trade."[5] The long depression after the Civil War bore heavily upon manufacturers, who saw their profits dwindling in the competition of a growing number of competitors for a limited amount of business. It was but natural, therefore, that large enterprises led by progressive and aggressive business men should seek a way out through business treaties, commonly called pools. Thus were formed the Gunpowder Trade Association of the United States (1872),[6] the Michigan Salt Association (1876),[7] and the Steel Rail Pool (1887).[8]

This form of association met with certain legal difficulties which showed the need for a more binding form of organization; it was replaced by the so-called trust. The pool practically left the separate organizations as they were as far as legal control was concerned, the managers simply agreed that their several corporations should conduct their respective businesses according to the terms of the pooling agreement. The trust accomplished its purpose through direct interference with the corporate management. The legal basis of the trust is the voting trust agreement (see page 117), under which the stockholders of the company turn over the legal title to their stock to a group of trustees, who as owners vote the stock, collect the dividends, and turn the latter over to the interested owners whose interests become evidenced by quasi-negotiable trust certificates. This arrangement puts the trustees in control of the company. Now, if the same trustees have control of several competing concerns in this way, we have what is popularly known as a "trust" and what is in effect a

[4] Cleveland and Powell, "Railroad Finance," page 278 In 1844 the Vermont and Massachusetts R R. Co. was organized as a consolidation of the Vermont and Massachusetts R. R and the Battleboro and Fitchburg R. R.

[5] A. S. Dewing, "Corporate Promotions and Reorganizations," page 114

[6] W S. Stevens, "Industrial Combinations and Trusts," page 2

[7] J. W. Jenks, *Political Science Quarterly*, Vol III, 1888, pages 79–98, reprinted in W. Z Ripley, "Trusts, Pools and Corporations," pages 1 *et seq*

[8] See C. W. Gerstenberg, "Materials of Corporation Finance," pages 496–8 It was not discovered until about 1913 that part of this agreement—that relating to prices—was oral See investigation of the United States Steel Corporation by the Stanley Committee of Congress.

combination of the constituent companies. Production policies as well as price policies are under the control of one board, a board of trustees, whose docile agents are the boards of directors of the several companies whom the trustees have chosen. In this way the old Standard Oil Trust was formed in 1879,[9] the Sugar Trust in 1887,[10] and the Whiskey Trust in 1887.[11]

Two decisions showed corporate lawyers that the trust form of organization was no less vulnerable from a legal standpoint than the pool had been.[12] Hence the astute lawyers for the trusts looked about for some new device that might avoid judicial condemnation. They hit upon the device of the holding company, by which the titles of shares of stock, instead of being turned over to trustees, were turned over to another corporation. This device was undoubtedly suggested by a provision in the corporation laws of the State of New Jersey which provided that "any corporation may purchase, hold, sell, assign, transfer, mortgage, pledge or otherwise dispose of the shares of the capital stock of, or any bonds, securities or evidence of indebtedness created by any other corporation or corporations of this or any other State, and while owner of such stock may exercise all the rights, powers and privileges of ownership, including the right to vote thereon."[13]

In 1901 occurred the great fight between Hill and Harriman which resulted in the formation of the Northern Securities Company to hold the stock of the Great Northern and Northern Pacific railroads. Again the courts looked through the form of the device—to the result of it as well as to its spirit. The United States Supreme Court held that the

[9] W. S Stevens, "Industrial Combinations and Trusts," pages 13 *et seq.* A later agreement in 1882 is the agreement spoken of as the Standard Oil Trust Agreement.

[10] *Ibid*, pages 27 *et seq.*

[11] J. W. Jenks, *Political Science Quarterly*, Vol IV, 1889, pages 296–319; reprinted in W Z. Ripley, "Trusts, Pools and Corporations," pages 22 *et seq*,

[12] Notice that it was at the time that these voting trust arrangements came into fashion that public attention was first forcefully directed to the problem of monopoly in the industrial field Newspapers referred to these monopolies as "trusts," an apt term for the organizations then in the public eye. But the term "trust" is now generally used in connection with industrial monopolies, whatever the legal form of organization may be. The two decisions referred to above are People v. North River Sugar Refining Co., (1890) 121 N. Y. 621, and State v Standard Oil Co., (1892) 49 Ohio State, 137.

[13] General Corporation Act of 1896, Sec. 51.

holding company, if its effect is to create a monopoly, is no more legal than any other device.[14]

Now it must not be inferred from this that every pool, trust, or holding company that has been organized is illegal. It is only when the effect of such arrangement has been to break the common law of monopolies or some statute bearing on monopolies, that the device has been condemned, although, to be sure, certain provisions of the common law of corporations may, as we shall see, interdict certain of these associations.[15] In thus reviewing the history of illegal intercorporate relations, we have been able to explain to some extent the *raison d'être* of the new fashions in intercorporate relations as they have arisen. The final step in the formation of intercorporate relations with a view to protecting the constituents from competition has been the community of interest.[16]

The community of interest takes most tangible form in what is known as interlocking directorates. Two companies will be brought into harmony by the holding of a small amount of stock, one in the other, insufficient in either case to control the board of directors, but large enough to warrant the controlling group of stockholders in each case in giving some representation on the board to the other company.

These interlocking directorates, as Prof. Ripley has shown, became practically powerless through the practice of conducting most of the business by means of an executive committee in which the "complimentary" directors were not included.[17] They apparently were more powerful during the twenties, for by means of them there developed the involved holding company structure and much of the frenzied financing of that decade.[18]

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[14] Northern Securities Co v United States, (1904) 193 U S 348

[15] Moreover, since the corporation is a creature of the State, and since the constitution of practically every State provides that corporate charters may be altered, amended, or repealed, each State may legislate in respect to intercorporate relations as it sees fit

[16] Just as, so sociologists tell us, there are examples of all forms of social life in existence in different parts of the world today, from savage tribal groups to modern democratic States, so in this year, 1930, probably many representatives of the various forms of intercorporate relations are to be found among American corporations

[17] W. Z Ripley, "Railroads, Finance and Organization," pages 121 *et seq* See also E Jones, "The Anthracite Coal Combinations in the United States," pages 71 *et seq*, and "Interlocking Directorates, the Problem and its Solution," *Harvard Law Review*, Vol XXVI, pages 467-92.

[18] Under the Public Utility Holding Company Act of 1935, a registered holding company or subsidiary is prohibited from having as an officer or director

Community of interest implies something more than interlocking directorates. For one thing, it includes the holding of stock of several companies by members of any group of persons whose interests, either through blood relationship, through long acquaintanceship, or otherwise, are closely associated. Thus the members of the group have some common interest which leads them to consult about and to agree upon directors for the several companies—directors who are quite certain to act in harmony. It can hardly be doubted that communities of interest exist, somewhat perhaps after the fashion above indicated, in most of the cases where the so-called trusts have been required by law to "unscramble"

Our historical survey has omitted sales of assets and leases of assets. The fact is that the survey was intended merely to indicate how new fashions of intercorporate relations arose as old ones were condemned. Consolidations, sales of assets, and leases, if not entered into with a view to monopoly, have not been prohibited, and frequent examples can be found throughout most of the period covered in the above historical review. Indeed, where the purpose is to bring corporations together to achieve some definite legal end, the standard legal forms used are consolidation, sale of assets, lease of assets, and the formation of a holding company, each of which will be taken up separately.

Intercorporate relations in the industrial field.—In the industrial field, a strong movement toward consolidation was evident from about 1882 to 1893. The depression that followed the panic of the latter year put a stop to consolidations until 1897, when the movement began again. It continued till 1903, when the industrial depression again halted promotions of consolidations. From 1905 until after the World War, there was a definite decline in the number of industrial mergers, due largely to the following causes (1) the trust had failed as a legal expedient and the disclosures attendant upon its failure had undermined the confidence of the public in consolidations, (2) the anti-trust laws discouraged promotion of consolidations; (3) public utilities replaced industrials in the interest of bankers and promoters as a field in which consolidation could be carried on.

any executive officer, director, partner, appointee, or representative of any bank or of any corporation the majority of whose stock is owned by a bank, except as the Commission may by rules and regulations permit This is but one example of legislation designed to curb interlocking directorates.

A general merger movement began anew in 1915. It gained vigor during the boom period of 1925 to 1929 and reached its climax in the latter year.[19] The causes of the revival in consolidation may be summarized as follows (1) The end of the war found us with a surplus of factories and products, and with unwieldy and inefficient organizations. Scientific methods of organization and control were applied as a cure for business ills. The result of the remedy was increased efficiency in both production and distribution, which opened the way to an increase in the size of business units. As efficiency increased, operating costs were lowered, prices declined, and profit margins narrowed Competition became keener The small business saw combination with larger units as a way to escape competition Big businesses could operate on narrow margins of profit only if they produced and sold in quantity Hence arose the tendency to reach backward to control the raw materials entering into finished products, to reach forward to control distribution, and to absorb smaller units in this expansion process (2) An expansion in markets required the operation of business in larger units. (3) Consolidation in one field lead to consolidation in another For example, the growth of chain stores required manufacturers selling to these distributors to be correspondingly large. (4) Prosperity and ease in marketing securities encouraged the promotion of large business units. (5) Public antagonism against large organizations had disappeared (6) The anti-trust laws no longer unreasonably repressed combinations The courts, through liberal interpretation of the anti-trust laws, had recognized that larger business units had a stabilizing effect upon industry.[20]

During the thirties few industrial consolidations were undertaken The reasons may be summarized as follows: (1) the depression discouraged combinations; (2) the trend

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[19] From the year 1919 till 1927, the yearly number of mergers effected increased 225 per cent "Recent Economic Changes," National Bureau of Economic Research, 1929, page 184

[20] The desire of men who have passed the prime of life to be rid of business struggles undoubtedly gave some impetus to the movement in this as in earlier periods Moreover, bankers desirous of keeping large selling organizations busy contributed to the demand for new issues of securities which combinations could readily supply.

in other fields, notably public utilities, was toward simplification of corporate structures; (3) the Government showed an inclination to follow an anti-monopoly program, the exact nature of which remained unknown; (4) "big business" had been put on the defensive by economists and statisticians who proved that a substantial portion of the nation's wealth was concentrated in the hands of a comparatively small number of large corporations;[20a] (5) suggestions were rife that unmerging might be profitable to "big business."[20b]

Intercorporate relations in the railroad field.—In the railroad field, consolidations may be roughly divided into four periods [21] from 1853 to 1873 the roads combined in an end-to-end formation, with the purpose of establishing better connections between large cities. From 1873 to 1893 the consolidation movement looked toward the formation of complete railway systems. The years from 1893 to 1910, covering the period when industrial combinations were attracting the attention of business men, were characterized by frenzied consolidation in the railroad field. Consolidations were formed with the purpose mainly of obtaining greater administrative and financial control over whole sections of territory. This movement culminated in the Northern Securities decision previously mentioned,[21a] which, with the retarding influence of industrial depression and restrictive railroad legislation, put a stop to railroad combinations. The next period of consolidation began in 1920 with the return of the roads to private ownership and with the enactment of the Transportation Act of 1920, which legalizes consolidation with the

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[20a] See footnote 1, page 51 In the hearings on bills proposing the Federal licensing of corporations, introduced in the 75th Congress, Third Session (1938), an impressive list of facts, summarized from various sources dating from 1926 to 1931, was placed in the record to show the extent of concentration in the business world See page 512, Part 4 of the Hearings

[20b] See a series of articles on Government and Business, which appeared in *Fortune*, beginning Feb , 1938 Attention was called in one of these articles to the general impression which prevails that the early mergers were unsuccessful or were successful only after ten or fifteen years of disappointing earnings A more recent study of the performance of consolidations organized from 1888-1905 shows the need for modification of this impression. See F H Knight, "The Success of Industrial Mergers," *Quarterly Journal of Economics*, November, 1935.

[21] See A S. Dewing, "Corporation Finance," page 257

[21a] See page 611

approval of the Interstate Commerce Commission. Although occasional instances of the use of railroad holding companies were known in the early history of railroads, it was during the twenties that the railroad holding company developed as a dominating influence in railroad organization and control. The depression abruptly terminated all interest in consolidation and the further development of the holding company. The latter, in fact, has undoubtedly passed its peak in importance. When a revival of the consolidation movement will occur cannot be foretold. The railroads are heavily indebted to Government agencies for financial aid, they face bitter competition from motor cars, oil and gas pipe lines, electrical transmission lines, and the aeroplane, they are regulated as to rates, routes, wages, and securities, all of which make it difficult to offset losses arising from decreased traffic. These are some of the conditions which indicate that consolidation alone will not solve the railroad problem.

Intercorporate relations in the public utility field.—In the public utility field the most important combinations through absorption of local companies by holding companies date back to 1890. Consolidations occurred at this early date principally for two reasons: (1) competition between companies serving the same locality impaired financial safety of the companies and prevented adequate service; and (2) consolidation of small units meant increased financial strength and better service. The next era of consolidation began with the expansion of public utilities just prior to the World War. First there was a consolidation of neighboring operating companies into larger operating companies. Later there was a consolidation of large operating companies under the common ownership of the holding company. The abuses practiced by the holding company, most of which are enumerated in Section 1 of the Public Utility Holding Company Act of 1935, led to the passage of that law. The Act places public utility holding companies and their subsidiaries, as defined therein, whose interests and activities are interstate in character, under the control of the Securities and Exchange Commission. A specific duty is imposed upon the Commission to take definite action toward simplification of holding company systems. The trend in the public utility field, intrastate and interstate, is toward corporate simplification. This generally means

mergers, consolidations, and dissolutions of separate corporate entities.[22]

Kinds of combinations.—Changes have taken place not only in the methods of combining business units, but in the kinds of businesses that are brought together. The earliest form of combination united under one central control businesses engaged in the same branch of production, whether or not they were in direct competition. This type is known as a *horizontal* combination. The earlier consolidations, such as the Standard Oil Trust and the American Tobacco Company, were examples of horizontal combinations. The weakness of this type of merger lies in the fact that the organization cannot control suppliers of raw materials or consumers of the articles produced, unless it aims at monopoly. It was the efforts of the old time trust to form a monopoly through horizontal combinations that led to the anti-trust legislation.

As the horizontal combination did not accomplish its aim, a new form of combination developed, known as the *vertical* merger. A vertical combination brings together under one managerial control business units engaged in several stages of the industrial process. Such a combination tends to reach backward to acquire access to raw materials, or forward to control marketing, or to do both. The United States Steel Corporation is one of the earliest examples of vertical combination, though it is really an example of both a horizontal and a vertical combination. Another example is the International Harvester Company. The Federal Trade Commission's report on high prices of farm implements[23] undertook to show that this vertical combination brought under the direction of a unified management, control of the whole process from raw material to finished product. This company, says the report, "manufactures or controls the manufacture of practically all the raw materials it uses, with the exception of paints.

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[22] The Niagara Hudson Power Corporation, for example, was formed by a consolidation in 1937 of a constituent company and its subsidiary, in a simplification process which was summarized as follows in the company's annual report for 1938 "A reduction by 16 of the number of System companies was accomplished during 1937. Whereas at the end of 1929 the System comprised 59 companies, there remain today but 20 During the eight-year process of simplification, 11 companies were organized or acquired. Therefore, a total of 50 corporate units have been eliminated from the System since 1929."

[23] "Report of the Federal Trade Commission on the High Prices of Farm Implements," 1920, p 48.

It owns iron ore and coal property and operates iron, steel, and coke plants. One of its subsidiaries, the Wisconsin Lumber Co., owns extensive timber property and produces pole stock and other materials. The Harvester Company has also special facilities for obtaining from the Philippine Islands and Yucatan manila and sisal fibre used in the manufacture of binder twine. In addition, the company owns and operates several small industrial railroads. Through the foregoing and other auxiliary operations the International Harvester Company is able to obtain most of its raw materials at production costs. This gives the company a large advantage, as few of the other companies control their raw materials." Beyond the description given, the integrated operations of this company include a marketing organization of great strength. In the motor industry, the Ford Motor Company and the General Motors Corporation are examples of integrated concerns.

While recent combinations have been largely of the vertical variety and have shown a tendency toward further integration, still in many fields concentration of control has resulted in large scale horizontal combinations. For example, in the public utility field the combinations have been of both varieties

The most recent form of combination is that known as the *circular* combination. This type brings together business units making allied or supplementary products which are unrelated except that they have the same distribution outlets. The General Motors Corporation and the General Foods Corporation are examples of circular combinations. Since the units combined are producing non-competing products, there is less danger of monopoly and of prosecution under the anti-trust laws. The circular type of merger is that which has recently made the greatest progress. Indeed, future combinations are likely to take this form since its principal aim, which is to effect economics in distribution, attacks industry's most difficult problem today—the efficient and economical distribution of its products.

Advantages of combination.—It is not intended to enter here into a discussion of the social effects of monopoly, nor to analyze the claims made for large scale production to see to what extent these claims may in practice have fallen short of realization; no attempt will be made to weigh social disadvan-

tages of combination against the advantages to the private interests concerned in the combination. We shall merely point out those advantages of combination which might, for example, be used by the promoter of a combination in inducing constituents to join his promotion. Incidentally we shall point to some of the difficulties of large scale production and to some of the abuses of combination, in order that they may act as warnings to the would-be promoter who has not had an opportunity to profit by the shortcomings of others.

The advantages here pointed out must not be considered wholly academic. They have actually been drawn upon in formulating consolidation prospectuses, as the three following quotations, excerpted at random from official corporate circulars, will show. The first is from a circular announcing the sale of bonds of the Dominion Canner's, Limited:

Objects of Consolidation.—To make one strong company with sufficient experience and capital to not only supply the Dominion of Canada, but many other countries, with the finest goods that can be packed and at the lowest possible prices.

By concentrating the buying of supplies, larger purchases may be made at lower prices.

By having only one, or at most, two selling agents in large centers instead of forty, as formerly, large savings in commissions can be effected

By shipping goods from factories to nearest points of delivery, freight charges are reduced

By specializing the packing of certain lines at certain factories, the quality can be improved and cost lessened

The second quotation is likewise from the circular of a Canadian Company, Sherwin-Williams Company of Canada, Limited:

Objects of Consolidation—Large economies will be effected by utilizing the manufacturing facilities of each company for the benefit of the common interest By confining the manufacture of certain products to the plant where they can be most economically produced, and handling the entire output of some articles in one plant instead of three, considerable saving can undoubtedly be accomplished.

It will be the object of the new company to produce and control practically all of its important raw materials, including dry white lead, thus guaranteeing lowest cost with highest quality.

The third quotation is from a circular sent to stockholders of the Chino Copper Company, asking them to approve consolidation with the Ray Consolidated Copper Company:

The immediate benefits to be gained, from the corporate standpoint, lie in a consolidation of business and production that will make for economy and advantage in overhead and organizational expenditures, in the disposition of product, and otherwise From a strictly operating standpoint, many advantages can be gained through a closer working relationship between production organizations, both executive and technical, thus making available to either property at all times—and where most needed—the best specialized skill and talent of both From the standpoint of stockholders, these factors will be augmented by a beneficial diversity of interests wherein best advantage can be taken always of the situation surrounding both properties as a whole, in times of stress, such as have prevailed in the recent past—as, for example, by continuing major scale operations at the most economical producing point and decreasing output at the other, when the metal market would not absorb production from both, or by balancing output when, due to seasonal conditions, accident, labor situation, fuel supply, transportation, or any other of numerous causes that may affect output, it is impossible to maintain full production at one property, while at the same time it is quite practicable to do so, or even to increase production at the other.

Classification of advantages.—The advantages of the combination of several businesses may be classified under three headings. (1) large scale production, (2) advantages of combination of units, (3) elimination of competition. Each one of these classes may be divided into several headings which we shall take up separately.

Large scale production.—Large scale production yields some advantages in almost every department of business.

1. *Production*.— Large scale production permits the introduction of machinery, the cost of which could not be borne by a concern making little use of the machinery. It enables a concern to engage expert technical ability, to maintain a department of research, and to make tests that a smaller concern cannot afford That combination permits economy in research is illustrated by the proving ground maintained by the General Motors Corporation, on which tests for all cars produced by its subsidiaries are made. One proving ground for the seven automobile manufacturing divisions of the company is maintained at a cost not much greater than it would be if the ground were designed for a single division. Research on a large scale may lead to inventions or discoveries that revolutionize the industry. The company in control of the innovation has, of course, an advantage over competitors. Related to research is the control a large company can have

over patents. It is in a position to acquire patents that affect its product or its processes, and to prevent infringement of patents which it owns. Large scale production, moreover, encourages specialization. If one man, for example, can make one part of an automobile, or perform one operation in the making of that part, advantage is gained not only from the expertness of the workman, but also from the fact that time is saved by the elimination of a change from one operation to another.[24] Large business houses are able to maintain schools for the instruction of employees and in that way are able to get better assistants than the small concerns. The welfare work attracts and holds the employees and the fact that the profit is likely to be relatively large in the business that is prosecuted on a large scale means that wages can be higher. By-products that a smaller concern might have to neglect become an important source of revenue for large concerns that can afford to work the by-products up into salable commodities. Gas houses and packing houses furnish excellent examples. Moreover, a part of production cost is interest on the capital[25] and large scale production permits the spreading of this cost over a large number of units of product. The same is true of administrative expenses It must not be thought that these advantages can go on indefinitely. There is a size beyond which a business cannot go without losing in respect to care of management and co-ordination.[26]

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[24] Adam Smith's classic example of pin-making is familiar to most students of economics The savings of specialization in the slaughtering and dressing of cattle have also been frequently pointed out See G D Babcock, "Taylor System in Franklin Management."

[25] The author appreciates the arguments against including interest as a cost of production (see his "Principles of Business," pages 722 *et seq*), but the statement made in the text may be permitted to stand, even by those opposed to the inclusion of interest in "costs," as an assumption which even if false does not invalidate the general argument as to the value of large scale production.

[26] This idea is not as widely held today as it was two decades ago, largely on account of the fact that "recent developments in management methods and in accounting and statistical control, have apparently broken down these former economic limitations on the size of the individual organization or 'chain' . . . " See "Recent Economic Changes in the United States· Report of the Committee on Recent Economic Changes of the President's Conference on Unemployment," Vol. II, page 864. While the American Telephone and Telegraph Company, the United States Steel Corporation, the General Motors Corporation, the Standard Oil companies, and others may be pointed to as giant corporations maintaining the highest standards of efficiency, it nevertheless remains true that unless good management accompanies expansion, losses will increase.

2. *Purchasing.*—Large scale production means large scale purchasing and this always makes for saving, for lower prices, and for buying just what is wanted when it is wanted. For example, a concern that is large enough may buy its coal by the calories, or heat units, instead of by weight; but the concern must be large enough to buy so many tons of coal—to use the ordinary unit of purchase—that the cost of analyzing the heat content will be negligibly small per unit of purchase.

3. *Marketing.*—In modern times, distribution has been the most trying of industrial problems and many circular consolidations have been effected largely to overcome marketing difficulties. The middleman or jobber has disappeared in many fields because of the creation of larger business units. For example, the central purchasing department of a group of chain stores will do the buying for the organization directly from the manufacturer, cutting out the middleman entirely. Similarly, the consolidation of manufacturers has led to the creation of branch offices that perform the distributing function originally performed by the jobber. In fact, the tendency in some fields seems to be to create combinations that will permit a distribution of products direct from producer to consumer. Chain stores, such as the Walgreen drug stores, which are continually opening new retail stores and at the same time acquiring their own producing sources, are an example of the modern movement.

Large scale production has these marketing advantages: it leads to large sales at small profits; it spreads selling costs over a great number of products; it cuts down wasteful selling expenses; it permits nation-wide advertising; it enables the business to search out markets that a small concern cannot afford to reach.

It is true that some of these advantages may be gained by small concerns co-operating for this purpose only, that is, for foreign trade, and without combining for production, but the fact remains that heretofore the American concerns that have painted their signs on the rocks of Asia and planted their billboards in the sands of Africa have been the large closely-controlled industrials.

4. *Financing.*—Large scale businesses enjoy distinct advantages over smaller competitors from the financial standpoint. Issues of securities are larger and therefore command a wider

market, perhaps an international market. The profits that can be made from financing are sufficient to attract the attention and engage the assistance of large financial interests. Larger sums of capital for fixed and liquid assets will be available, thus enabling the business not only to weather a period of financial strain, but to make the most of those opportunities which our system of fluctuating prices presents from time to time.[27]

With centralized control of cash, the rate of turnover of capital may be improved. Borrowing may be cut down as the diversification of operations makes funds in one place available for use at another. With reduced borrowing, smaller cash balances are required, and turnover of capital can be increased. Savings can also be effected by centralized control of credits and collections, by reducing the expense of credits and collections, by reducing bad debt losses, and by increasing the turnover of receivables. Insurance costs are likely to be reduced as better rates due to larger volume of coverage are obtained. Or if no saving in that way can be made, other insurance advantages may be gained. Thus the larger company may be able to secure coverage that the smaller company could not, simply because it is offering more good risks along with the bad ones.

5. *Accounting.*—Finally, large concerns can install systems of accounting and of statistical analysis and control that a smaller concern must forego, since the cost of handling ten thousand items is very little less than the cost of recording and analyzing millions of items. Greater efficiency in administration can also be attained by proper supervision of the clerical force. Economies can be effected by keeping the staff fully occupied every day.

Advantages of combination of units.—There are certain advantages that flow from the mere fact that a number of business concerns that were going about their own way have combined.

1. *Increased earnings.*—Larger earnings are, of course, one of the advantages expected to be gained by consolidation; in some cases greater stability of earnings is a persuasive argument used to bring smaller units together. With improved

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[27] See C. W. Gerstenberg, "Materials of Corporation Finance," pages 542–554.

earning power come better credit standing and economies in the cost of raising capital.

2. *General user of patents.*—In the second place, the several plants of a combination can use the patents, secret processes, and efficiency methods of the most successful among them.

3. *Integration of industry.*—Then, too, the successive processes whereby goods are brought from the stage of raw material to the form of consumption goods may be combined in such a way as to reduce the friction of moving the goods, to cut out the profits at the different stages of production, and to stabilize the flow of goods and the use of labor.

4. *Fluctuation reduced.*—Combined companies can regulate their business operations. For example, the sugar trust arranged its production in such a way as to keep all its plants, except the one at Williamsburg, Brooklyn, constantly busy at 100 per cent capacity. The Brooklyn plant was one of the largest and was located in a labor market that could easily absorb the labor laid off in seasons of slack and that could yield labor when required. Stabilization leads in addition to economies in operation and regularity of earnings. The recent movement, through circular consolidations, toward control of distribution by diversification of production, has helped considerably to stabilize production in many industries.

5. *Specialization of plants.*—Where there are several concerns doing about the same line of work, in some features one concern will excel the others. This excellence may be due to some fortuitous circumstances, such as plant location, to the training of its managers, or even to such an intangible thing as traditional pride in the selected feature. A combination of plants will enable the concern to concentrate in each plant the things that it is able to do best. Operations may be rearranged so that one plant produces one product and another plant a different product.

6. *Cross freights.*—Where a combination is made of several concerns in different parts of the country, cross freights may be saved if all orders are filled from the plant nearest the customer's place of business. Furthermore, costs of transportation are reduced as merchandise is moved in bulk. If the business is large enough, economies may be effected by maintaining private transportation facilities.

7. *Psychology.*—Moreover, the combination of several plants invites the play of psychological forces, the importance

of which can hardly be exaggerated. One public utility holding company, for example, with over a hundred subsidiaries, keeps a scoreboard for its subsidiaries that goes far in the direction of keeping the local managers close to maintaining 100 per cent operating efficiency.

Eliminating competition.—Finally, combination leads to the elimination of competition. A number of advantages may flow from maintaining a dominant position in an industry

1. *Prices*—At one time monopoly was the aim of combinations and monopoly prices the result. The price policy was to get all that the traffic would bear. Modern combinations, however, do not tend toward monopoly and monopoly prices. Rather, a narrowing of profit margins has been noticeable in the modern mergers and a passing on of part of the economies of consolidation to the public through a reduction in prices. The reduction of competition has the further effect of stabilizing prices. It has also been noticed that in industries that are dominated by a few large corporations, destructive price cutting has been minimized.

2. *Control of customers.*—If competition is eliminated, buyers may be made to pay their bills promptly and to refrain from taking cash discounts to which they are not entitled, the threat of going to a competitor cannot be used to make the seller consent unwillingly to such commercial extortion. Nor can the purchaser make unfounded claims for shortages and spoiled goods.

3. *Elimination of selling costs.*—A large part of selling effort is used not to get customers to buy certain commodities but to get them to buy a certain kind of those commodities made by a certain house. Perhaps this appeal for the trade of the public at the expense of competitors accounts for the largest part of our advertising costs. Certainly one who reads the advertisements in our popular magazines would feel justified in attributing the lion's share to this purpose. The elimination of competition will eliminate these selling costs. Money can be spent to induce farmers to buy a milking machine instead of to steer them away from all other milking machines to that of the advertiser. Considerable progress has been made through circular combinations, through the efforts of trade associations, and through the formation of groups for the purpose of joint advertising, in cutting down waste in advertising.

Destructive competition.—Competition itself uses up vital energy that might be devoted to improving production, financing, marketing, and accounting methods. Business in the past twenty odd years seems to have taken cognizance of this fact and has turned from the belief that the only cure for competition is consolidation with monopoly as the ideal, to the belief that the cure for competition is large scale production with wider markets of distribution. Instead of fighting over existing markets, the large business organization today creates new markets. Competitive wars have been stifled by the Sherman and Clayton Acts, by the vigilant handling of cases of unfair competition by the Federal Trade Commission, and by the constructive efforts of the trade associations. But competition has not disappeared; its character has merely changed. In place of price competition, there is now competition for control of extractive and distributive processes.

Disadvantages of large scale production.—We must not conclude that large scale production, combination, and an approach to a monopoly are the sure guarantees of business success. Too many corporations with these advantages, in varying degrees of completeness, have shown the fallacy of the assumption. Size often engenders extravagance, neglect of details, and "inflation in management."[28]

Mere bigness is apt to lead to squandering, to the creation of a detached impersonal attitude on the part of employees of all ranks that stands in contrast with their direct personal interest in the concern's welfare when it is owned, worked, and managed by the same people.

In some instances large business has invited—so corporate history has shown—neglect of business details; attention is improperly directed toward pecuniary management—stock jobbery—from the workings of which larger and easier profits may be hoped for than from strict attention to the business processes. Thus Professor Dewing has shown that much of the unfortunate history of the Cordage combinations was due to the fact that sitting at a mahogany desk in the Wall Street district of New York was a pleasanter occupation than a shirt-sleeved existence in the office of a Greenpoint ropewalk.[29]

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[28] See Chapter XIX, "Expansion."

[29] A. S. Dewing, "Corporate Promotions and Reorganizations," Chapter V, and see especially pages 557–566

Another difficulty, which is very real in business, arises from the scarcity of high-grade managerial ability. In the various plants brought into a combination there may not be the managerial skill necessary to fill the positions calling for rare administrative ability. Much will depend on circumstances. Where a business grows like the Standard Oil Company, gradually taking in new interests, the chief organizing ability may improve as the demands are made upon it, but where a new organization of large dimensions is suddenly created by the coalition of many fairly small concerns, either disaster is likely to follow, or a shifting about of managers occurs in the early years to make way for the competent man, be he insider or outsider, who can cope successfully with the peculiarly difficult problems which a complex enterprise presents.

Finally, large scale production and combinations may attract public opposition and opposition of customers. The attacks on the meat packers are examples of public opposition. There have been a number of examples of opposition to a business voiced by customers simply because it is a combination and popularly known as a trust.[30] In the recent merger movement, antagonism of this kind was not felt, but opposition to "big business" was definitely noticeable during the post-merger era

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[30] See A S Dewing, "Corporate Promotions and Reorganizations," pages 561–2.

Chapter XXIX

CONSOLIDATION

The problems of intercorporate relations.—Three fundamental questions present themselves to one who undertakes the study of intercorporate relations. (1) how are intercorporate relations legally formed; (2) what rights and obligations flow out of the several forms of intercorporate organization; and (3) what are the bases upon which the ownership in the new combined organization should be distributed?

What is a consolidation?—Consolidation is the term ordinarily applied to an out-and-out fusion of corporations. Let us say that the consolidation of companies *A*, *B*, and *C* has somewhat the same effect as the pouring of three different solutions into a single glass. Perhaps even a better way to get at the effect of consolidation is to liken it to the organization of a corporation by other corporations whose identities are lost in the company they form.

Where two or more companies organize a new consolidated company, the result is called an amalgamation; where several are fused into one already in existence, the result is called a merger. Let it be understood, however, that popularly, in the newspapers and magazines, the distinctions here made between consolidation, amalgamation, and merger are not always observed. One word is frequently made to do duty for another. Careful students, however, should observe the distinction, though in fact in this country the difference between merger and amalgamation, as far as the result is concerned, is merely a question of whether a new corporate name is used or whether one of the old corporations lends its name to the consolidation.

How consolidations are effected.—Just as an enabling act is required as the basis of a corporation, so is a statute permitting consolidation required as the basis of a consolidation. If a consolidation is undertaken without statutory permission, the constituent companies are guilty of an *ultra vires* act.

Where the corporations about to be consolidated were originally organized in different States, the consents of the several States must be obtained. The statutes vary from State to State not only as to the procedure for effecting a consolidation, but also as to the kinds of corporations which may consolidate. In many of the States only domestic corporations may combine, while in others the statutes definitely permit domestic and foreign corporations to consolidate. In still other States the law permits domestic and foreign corporations to combine if the laws of the other States involved permit consolidation with corporations organized elsewhere.

The procedure in consolidation is ordinarily as follows: The directors of the several companies pass resolutions ordering the consolidation and calling upon the stockholders to express their opinion; the stockholders, usually at a special meeting, consider the proposal to consolidate and if the number of individual stockholders required by statute sign written consents, a written agreement of consolidation is executed, which, with the written consents, is filed in the public offices wherein certificates of incorporation are filed.[1] Thereupon the consolidated company comes into being, and there remains only the exchange of certificates of stock of the consolidated company for the stock of the constituent companies.[2]

Objecting stockholders.—People familiar with such affairs realize that whenever any form of corporate reorganization takes place, there are always some stockholders or creditors ready to raise objections, sometimes perhaps in good faith, but frequently for the purpose of showing that in objecting they are consistent with their past records in this respect, and more frequently, it is to be feared, for the purpose of forcing a settlement of their claims on a basis hardly to be distinguished from blackmail.[3] It is important, therefore, that

[1] The exact form of this certificate will depend on the wording of the statute under which the consolidation is organized

[2] Under the Transportation Act of 1920, consolidation of interstate railroads is under the control of the Interstate Commerce Commission Consolidations to effect simplification of the corporate structures of holding companies subject to the Public Utility Holding Company Act of 1935 are under the control of the Securities and Exchange Commission

[3] Professor A. S Dewing makes the same point in his "Corporate Promotions and Reorganizations," page 105, and gives a very apt illustration

Some even of the stockholders of the Corn Products Company pretended to consider themselves unfairly treated in the reorganization and alleged a conspiracy by E T Bedford and his

when corporations consolidate, they follow exactly the terms of the statute authorizing the consolidation.

The statutes of some States, New Jersey, for example, provide that only such corporations as are engaged in the same or similar lines of business may consolidate. Here is a question for difference of opinion: are two companies that have formed a consolidation really in the same or similar lines of business? Suppose, for example, company *A* has powers *x* and *y*, and that company *B* has powers *x*, *y*, and *z*. May they consolidate, assuming that company *B* is not exercising power *z*? It is a general rule of corporation law that corporations are not guilty of non-user of corporate powers if they do not exercise all their powers. With this latter rule in mind, consider what might happen to an investor who had put his money in company *A*, if the two companies were permitted to consolidate. He had committed his funds, let us say, to the hazards of the *x* and *y* business; after consolidation, the consolidated company would have the joint powers of companies *A* and *B*, and therefore would have the right to exercise the power *z*. The company might, in fact, decide to discontinue the exercise of its *x* and *y* business and concentrate on the *z* business. Thus, if powers *x* and *y* were those of building, and of buying and selling real estate, and power *z* was that of dealing in automobiles, the consolidated company would become an automobile business and an investor in company *A* who originally had no idea of committing his funds to any but a contracting and real estate business, would find himself in the automobile business. Hence, it would

associates,—whom the bill declared were commonly known as Standard Oil people—with the old directors of the Corn Products Company, to defraud the stockholders of the latter company of their property. The feelings that existed between the Presidents of the two Companies were hardly such as to have encouraged a conspiracy. Some of the allegations made in the bill were at least entertaining in view of the history of the combination. For example it was alleged that the stockholders of the Corn Products Company were discouraged as much as possible by such reports as would induce them to sell out or transfer their stock. The bill further declares, "from the beginning the Company has been subjected to attack by the Standard Oil Company. One method was the construction of a factory for the New York Glucose Company by Bedford and his associates. This method failed and it was then attempted to buy the stock of the Corn Products Company by depreciating the stock values, and by sales of large quantities of stock on different exchanges in large amounts, and buying it in again at a lower figure. The $50,000,000 of common stock was cut down by false sales to one-tenth of its supposed value, while $30,000,000 of preferred stock was depreciated to one-quarter of its par value." This incident illustrates admirably the difficulty of effecting a fair reorganization without the aid of the courts and a judicial sale of the old company's property. There are always stockholders who consider themselves aggrieved. Most serious of all there are always hordes of speculators and unscrupulous attorneys who stand ready to bring suit against a company, ostensibly to obtain rights in the name of justice, but actually to compel the large corporation to buy its peace at secret and exorbitant terms. In the present instance the fact that the Corn Products Refining Company was under the control of men connected with the Standard Oil Company was made much of in the public press, apparently to prejudice public opinion against the Company.

appear, the powers of the consolidating companies must not only be similar in kind but similar in amount.[4]

Rights of objecting stockholders.—It would seem from what has been said that objecting stockholders may have two grounds for objection: (1) the proposed consolidation is illegal; (2) the stockholder does not deem it expedient. To protect himself from injury on ground (1), he may start an action for an injunction in an equity court, and to protect himself against ground (2), he may have recourse to certain statutes provided in most States for the protection of minority stockholders who do not wish to be forced into a consolidation against their will. These statutes usually provide that the disgruntled minority stockholder may apply to a court of equity which will appoint appraisers to appraise the money value of the applicant's stock. The appraised value is then paid by the consolidation, as well as the expenses of the proceedings for valuation, and the objector's stock is canceled.[5]

Effect of consolidation on stockholders and creditors.—The stockholders of the constituent companies become stockholders in the new company on an agreed basis,[6] and the creditors of the constituent companies become creditors of the consolidated company, though their equities in specific properties are preserved as far as possible.

The extent of the problem involved in consolidations, and its solution, will be better appreciated and understood by one who carefully examines the following exposition of a hypothetical situation.

Company *A*	Company *B*
(1) Stockholders	(1) Stockholders
(2) Mortgage creditors	(2) Mortgage creditors
(3) Unsecured creditors	(3) Unsecured creditors

Company *M*

(1) Stockholders
(2) Mortgage creditors
(3) Unsecured creditors

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[4] The specific question came up in the consolidation of the United States Leather Company and the Central Leather Company. See A. S. Dewing, "Corporate Promotions and Reorganizations," pages 45–6. The opinion referred to in Dewing will be found in Colgate v. U. S. Leather Co., (1909) 75 N. J. Eq. 229. See also Copeland v. United Shoe Machinery Co., (1915) 84 N. J. Eq. 276.

[5] For a case in point explaining other methods, and citing other cases, see C. W. Gerstenberg, "Materials of Corporation Finance," pages 1019–21.

[6] See pages 634 *et seq.* for discussion of financial basis of consolidation.

Companies *A* and *B* consolidate into company *M*. Each constituent has stockholders, mortgage creditors, and unsecured creditors. After consolidation, the consolidated company incurs debts, *M* (3), and issues a mortgage on the consolidated property to *M* (2). What are the rights of *A* (1), *A* (2), *A* (3), *B* (1), *B* (2), *B* (3), *M* (1), *M* (2), *M* (3)? In fact, *M* (1) takes the place of *A* (1) and *B* (1); we may also say at once that all debts must be paid off before stockholders share in the proceeds of liquidation and that *M* (1) will get what is left after that has been done. The general rule as to mortgages is that specific liens are not disturbed. *A* (2) therefore has a first lien on property *A*, *B* (2) has a first lien on property *B*, and if we assume for the sake of simplicity that the only property *M* has is *A* plus *B*, then *M* (2) has a second lien on properties *A* and *B*. How about *A* (3) and *B* (3)? A consolidated company assumes the debts of its constituents, and these unsecured creditors therefore may sue the new company to recover the amount of their indebtedness. But they may go still further. The rule is stated by one legal authority thus:

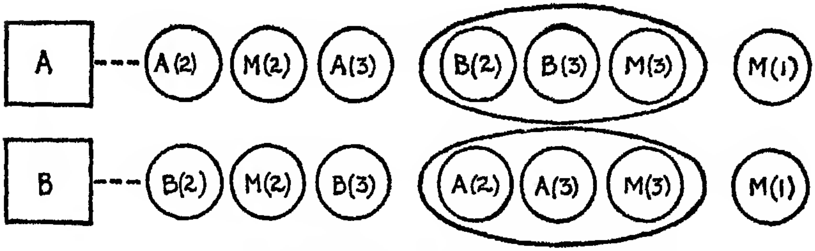
> A corporation holds its property as a trustee, first, to meet its obligations, and, afterwards, for the benefit of its creditors It cannot give away its property or enter a consolidation, the effect of which is to transfer its assets and terminate its existence, to the prejudice of its creditors. A consolidated corporation is not a purchaser for value without notice, and a court of equity will treat the assets of a consolidating corporation as a trust fund for the benefit of its creditors and, upon its consolidation with unpaid debts, will pursue its assets and lay hold of them in the hands of the consolidated corporation and apply them to the payments of such debts . . . Where, however, the consolidated corporation has sold the property so acquired to a *bona fide* purchaser for value, a creditor cannot follow it.[7]

It appears, then, that property *A* must be used first to pay the *A* (1) mortgage on it, then the *M* (2)[8] mortgage, then the *A* (3) unsecured creditors, and then any other debts that may remain unpaid. The same arrangement will hold for property *B*. The situation as a whole may be summarized in the fol-

[7] W C. Noyes, "Intercorporate Relations," Sec 87

[8] The question is sometimes raised how is it, in view of the rule quoted in the previous paragraph, that *M*'s mortgage comes in ahead of *A*'s unsecured creditors? The answer is that company *M* stands in the shoes (if we may be permitted that figure of speech) of company *A*, and since company *A* ordinarily could have placed a second mortgage on its property, (assuming, of course, that the company was not insolvent, or if insolvent that the mortgage represents some property acquired by *A* at the time of giving the mortgage) so *M* can place a mortgage on the property that will have priority over the unsecured creditors.

lowing diagram, where the groups are arranged, reading from left to right, in the order of the priority of their claims in respect to each of the properties. All the groups in the ovals near the right-hand end of the line share as a single class; that is, they take what is left after paying the other groups in proportion to the size of their respective claims. It will be



Order of Liens Against Constituents of Consolidation

noticed that some of the groups, *A* (2), for instance, appear in both lines. This simply means, as to *A* (2), that it has a first claim against property *A*, but if property *A* is not of sufficient value to satisfy the claim in full, the unsatisfied part of the claim will run against property *B* in the position indicated.

Effects of consolidation on after-acquired clauses in corporate mortgages.—The explanation given above may seem complicated, but after all it is very simple and would be sufficient for our purpose were it not for the fact that companies frequently have after-acquired clauses in corporate mortgages covering all their properties. Since these corporate mortgages frequently secure large bond issues, and since the holders of other bond issues may also be interested in consolidations, we must pause for a moment to consider the effect of consolidation on bondholders whose claims are secured by mortgages with after-acquired clauses.

Some effect would undoubtedly be given by the courts to the consolidation agreement if it made reference to the mortgages of the constituent companies and gave the holders of bonds secured by such mortgages certain rights under the consolidation agreement. In practice, however, it is usual to close the mortgages of the constituent companies and if any further issues of bonds are necessary, to make them under a new and larger consolidated mortgage. It is therefore to the interest of the consolidated company to restrict the lien of the mortgages of the constituent companies to the properties

which the several constituents contribute to the consolidation, and to prevent such underlying mortgages from attaching to after-acquired property. In this way the security behind the new consolidated mortgage will be stronger. The courts have shown a disposition to encourage consolidated companies in maintaining this position.[9] It is quite clear that when several companies consolidate, one constituent cannot be said to be "acquired" by the other in such a way as to make the mortgage of the latter company cover the property of the former under the provisions of an "after-acquired" clause.[10]

Problems in the scientific method.—The scientific method of consolidation proceeds on the theory that a constituent has two distinct things that it can contribute to a consolidation, namely, assets and earning power. We shall not concern ourselves here with the intricate problems of the valuation of public utility companies for rate-making purposes, or for purchase by a municipality that has decided to operate its own utilities. To be sure, however, the principles of valuation developed in valuation cases by utility commissions and by the courts may be drawn upon with good effect by the drafters of a consolidation agreement, but in practice consolidation has proceeded on simpler and more rugged lines. It is our purpose to outline the scientific method as it has appeared in practice.

The two problems involved are: (1) assuming that the tangible assets and the intangible assets (that is, the excess earning power, explained later) are to be ascertained by independent appraisals of assets and audits of earning power, how shall the stock of the new companies be distributed; and (2) how shall the appraisals and audits be made?

The reader of the preceding paragraph may have hastily come to the conclusion that we have put "the cart before the horse"; that the first step should be the valuation of the assets. Now a moment's thought will show that the method outlined is the more scientific. In other words, the procedure

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[9] Railway Steel Spring Co v Chicago & E I R Co, (1917) 246 Fed 338, and cases there cited The statute under which the consolidation takes place will also have some effect on the liability of consolidated companies. Compare, for example, Irvine v. N. Y. Edison Co, (1913) 207 N Y. 425 (a consolidation under the Stock Corporation Law of New York), with Matter of Bergdorf, (1912) 206 N. Y. 309 (a merger under the Banking Law of New York)

[10] A Machen, "Modern Law of Corporations," Sec. 1865, and cases there cited.

here advocated rests on the theory that the *plan* of agreement should be founded on some logical rule, but that the actual distribution of the stock should depend on the application of that rule to the appraised value of the tangible assets and to the earning power of the respective companies. First decide on the plan, then get the facts and apply the plan to them and let the facts determine what the total capitalization of the consolidated company will be and what each constituent's share will be. In this way we eliminate the suspicion of prejudice in outlining the plan.

Brief outline of the scientific plan.—Before proceeding to give details, we can make our explanation clearer by very briefly outlining the scientific plan as a whole. The constituent companies under this form of agreement simply decide that all tangible assets shall be paid for with preferred stock at par and that the excess earning power shall be paid for in common stock. The excess earning power is usually called intangible assets or goodwill and is found by subtracting from the capitalized earning power the amount of tangible assets.[11] Thus, if the tangible assets amount to $100,000 and the net earnings of a company amount to $25,000 a year, and we consider that 5 per cent is a fair rate at which to capitalize the earnings, the capitalized earnings will be $500,000 and the excess capitalized earnings will be $500,000 less the amount of tangible assets ($100,000), or $400,000. This company, then, would have $100,000 of preferred stock and $400,000 of common stock.

In determining what are the tangible assets, it is customary to disregard the liquid assets, that is, cash and accounts, notes, and bills receivable.[12] The theory is that current assets of each constituent will be used to pay the current liabilities of the constituent companies and whatever is left over will be turned over to the stockholders of the constituent companies. This procedure has the merit, at least, of eliminating several elements that might complicate the problem of distributing the new stock, though it does add a new problem to the con-

[11] See Search v. Mason-Seaman Transp Co., (1915) 156 N Y. Supp. 579, reprinted in C. W. Gerstenberg, "Materials of Corporation Finance," pages 1019–21.

[12] See C. W. Gerstenberg, "Materials of Corporation Finance," page 517. In some cases, however, the liquid assets are transferred to the consolidated company, and bonds or preferred stock are given in payment therefor to the constituents

solidation proceedings—that of providing the new consolidation with adequate working capital. This working capital is frequently obtained through the issue of bonds or preferred stock.

An example of the scientific method.—To explain fully the plan of the scientific method without consuming an undue amount of space, we shall do well to employ some concrete hypothetical facts. We shall assume, therefore, that three companies, *A*, *B*, and *C*, are about to consolidate and that the essential facts concerning these companies are as follows:

Company	*Tangible assets*	*Average annual earnings for five years*
A .	$400,000	$ 40,000
B .	200,000	40,000
C ..	150,000	45,000
Total .	$750,000	$125,000

If we assume, now, that the savings of consolidation would amount to $50,000, our total earnings would amount to $175,000 a year. Let us assume that 10 per cent is a fair rate at which to capitalize. We are now ready to show how the stock of a new consolidated company, *X*, might be distributed. The scientific plan, it perhaps should have been said before this, does not provide a hard and fast division of stock, but merely implies a principle, namely, that assets shall be paid for in preferred stock and excess earning power in common stock. We shall now show several practical methods of applying that principle.[13]

Scientific method number 1.—The total capitalization will be $1,750,000 (the combined earnings plus the savings, capitalized at 10 per cent), from which will be subtracted $750,000 (the combined assets) to be distributed to *A*, *B*, and *C* in preferred stock for tangible assets as follows: *A*, $400,000; *B*, $200,000; *C*, $150,000. The remaining $1,000,000 of stock will be common stock that may be divided on the basis of earnings—40/125 to *A*, 40/125 to *B*, and 45/125 to *C*; that is, for *A*, $320,000; for *B*, $320,000, and for *C*, $360,000. Assuming now that all the stock will earn 10 per cent, as it

[13] See "Financing Problems of Modern Consolidations," by S. P. Meech, *The Journal of Business*, April, 1930, for presentation of several plans of distributing common stock under the scientific method of consolidation, proposed for a contemplated amalgamation which failed of consummation because of the human element.

should if our hypotheses are correct, the situation may be summarized as follows [14]

Company	*Preferred stock for assets*	*Common stock for earnings*	*Total*	*Income*	*Share of savings of consolidation*
A	$400,000	$ 320,000	$ 720,000	$ 72,000	$32,000
B	200,000	320,000	520,000	52,000	12,000
C . .	150,000	360,000	510,000	51,000	6,000
Total .	$750,000	$1,000,000	$1,750,000	$175,000	$50,000

One fact to be noted here is the amount which each company received of the savings of consolidation, which we assumed to be $50,000. The amount for each constituent is the difference between the old income and the income derived from the consolidation. *A*'s share is $32,000, *B*'s $12,000, and *C*'s only $6,000. One might ask oneself—especially if one had thought of simple economic principles—why should *A* receive so much more income than *B* or *C* when *A* contributed no more income than *B* and actually less than *C*? Indeed, the company with the largest income as a constituent has the smallest income now. True, the income as well as the stock is divided somewhat in proportion to the assets contributed, but after all, what are assets without earning power? A cynic might say they are worth a minus quantity since they represent so much more property to be kept in repair. But to pursue this argument further would lead us into the theme taken up elsewhere—the proper economic basis of capitalization. The fact is that we must find some other basis of distribution that will give more weight to the important element of earning power.

Difference between earning power and earnings.—It may be asked: why not divide the total capitalization on the basis of earning power alone, and disregard assets entirely? Such a solution would, indeed, be theoretically almost correct. But there are two difficulties here, one quite practical and the

[14] It is assumed in this example that the preferred and the common pay 10 per cent. If the preferred stock paid 8 per cent, the earnings to be capitalized in order to determine the amount of common stock would be the combined net profits less 8 per cent of the preferred stock, i.e., 8 per cent of the total assets for which preferred will be issued. Thus, in the example above, where the tangible assets equal $750,000, $60,000 would be subtracted from the earnings of $175,000 and $115,000 would be capitalized at 10 per cent, making $1,150,000 instead of $1,000,000 common stock to be distributed for earnings.

other somewhat theoretical. The practical objection arises out of the fact that the stockholders who have made large investments in their business would not sign an agreement that disregarded such investments entirely. The theoretical objection is that while earning power is important, earning power does need to be associated with capital investment.[15] It may be that company *C* has relatively high earning power, due, perhaps, to the energy, ability, and youth of its managers. But after all, a large part of the so-called savings of $50,000 may arise from the fact that this energy and ability will be applied, after the consolidation, to large plants. We must find, then, some plan that will neither disregard the assets entirely nor disregard earning power, or rather a method that will not confuse *earning power* and *earnings*. After all, company *A* and company *B* have the same earnings but not the same earning power. Company *A* has an earning power of $40,000 divided by $400,000 (earnings divided by capital), or 10 per cent, while company *B* has an earning power of $40,000 divided by $200,000, or 20 per cent. This leads us to a discussion of a second method of distribution.

Second method of distributing stock on scientific basis.—We assumed in our problem that 10 per cent was a fair basis of capitalization. Why, it may be asked, choose 10 per cent? The basis of capitalization may be fixed on the same train of reasoning that a utility commission or a court uses in arriving at a fair rate of return on capital in public utility rate cases, namely, taking all the circumstances into consideration, what rate of income would have to be promised to investors to persuade them to put money into the enterprise on the same terms of risk and control as the stockholders? We may assume, then, that in selecting 10 per cent as the basis for capitalization we have concluded that this figure is the return which one could expect from investing capital in a concern of this character without participating in the active management.[16]

In other words, unless a company can show 10 per cent of earnings on its capital, it is really not earning profits at all; it is merely earning compensation for the capital invested.

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[15] Compare the economist's Law of Proportionality. See J. R. Turner, "Introduction to Economics," pages 361–363

[16] See J. E. Sterrett, "Yield on Trade and Public Service Investment," *American Economic Review*, March, 1916.

Company *A* earned 10 per cent, company *B*, 20 per cent, and company *C*, 30 per cent. Thus company *A* really earned no profits at all; it earned merely a fair return on the investment We may cast up some of these preliminary facts in the form of a table.

	I *Tangible assets*	II *Earnings*	III *Rate of earnings*	IV *Rate of earnings in excess of 10 per cent*	V *Rate in column I applied to column I capital*
A	$400,000	$40,000	10%	0%	0
B	200,000	40,000	20	10	$20,000
C	150,000	45,000	30	20	30,000
Total	$750,000	$125,000			$50,000

If we capitalize as before at $1,750,000 (that is, capitalize the earnings of $125,000 plus the assumed savings of $50,000 at 10 per cent) and subtract from this the $750,000 required to pay for the tangible assets, we shall have left $1,000,000 of common stock to be distributed on the basis of the earning powers of the several constituents. The division may be on the basis of column III, or IV, or V. If column III is selected, for example, *A* would get $^{10}/_{60}$ of $1,000,000, *B*, $^{20}/_{60}$, and *C* $^{30}/_{60}$. If column IV is selected, *A* would get nothing, *B*, $^{1}/_{3}$, and *C*, $^{2}/_{3}$. If column V is used, *A* will get nothing, *B*, $^{2}/_{5}$, and *C*, $^{3}/_{5}$. The result may be cast up in tabular form as follows.

Division of common stock on basis of rate of earnings.

	Preferred stock for assets	*Common stock*	*Total*	*Income*	*Share of savings*
A	$400,000	$166,667	$566,667	$56,666 70	$16,666.70
B	200,000	333,333	533,333	53,333 30	13,333 30
C	150,000	500,000	650,000	65,000 00	20,000 00
Total	$750,000	$1,000,000	$1,750,000	$175,000 00	$50,000 00

Division of common stock on basis of excess rate of earnings:

	Preferred stock for assets	*Common stock*	*Total*	*Income*	*Share of savings*
A.	$400,000	None	$400,000	$40,000 00	None
B...	200,000	$333,333	533,333	53,333.20	$13,333.30
C......... .	150,000	666,667	816,667	81,666 70	36,666 70
Total	$750,000	$1,000,000	$1,750,000	$175,000 00	$50,000.00

Division of common stock on basis of excess rate applied to capital

	Preferred stock for assets	*Common stock*	*Total*	*Income*	*Share of savings*
A	$400,000	None	$400,000	$40,000	None
B	200,000	400,000	600,000	60,000	20,000
C	150,000	600,000	750,000	75,000	30,000
Total	$750,000	$1,000,000	$1,750,000	$175,000	$50,000

Another method.—It will by this time be understood by the reader that there is no one scientific method, but that the scientific method merely means making some allowance for tangible assets in preferred stock and some allowance for earning power in common stock.[17] Just what allowance shall be made in any given case is a matter for the parties to negotiate. Here we merely wish to present a number of bases on which negotiations may proceed.

Since the amount of prospective savings of consolidation is always a matter of conjecture, it sometimes is deemed advisable to neglect this item entirely and to capitalize the earning power at a rather low rate. Thus, instead of adding the prospective earnings to the actual earnings and capitalizing on a 10 per cent basis, the actual earnings only may be considered and these will then be capitalized at, say, 5 to 8 per cent. Moreover, instead of subtracting the stock to be issued for tangible assets from the total capitalization, the plan under consideration contemplates giving stock for tangible assets and additional stock for earning power. Suppose we capitalize our earnings on the basis of 8 per cent and see just how the agreement would work out.

	For assets	*Earnings*	*Capitalized at 8%* *(Common stock)*	*Total stock*
A	$400,000	$40,000	$500,000	$900,000
B	200,000	40 000	500,000	700,000
C	150,000	45,000	562,500	712,500
Total	$750,000	$125,000	$1,562,500	$2,312,500

Assuming that the savings actually do amount to $50,000 and that there is available, then, a total of $175,000 for dividends, and that the preferred stock is 8 per cent non-participating, we would use up for preferred dividends $60,000 (8

[17] Theoretically it is not necessary that preferred and common stock shall be used. The stock may be all of one class

per cent of $750,000) and would have available for common stock $115,000, and this would pay dividends at the rate of somewhat more than 7 per cent; the several constituents would receive total income from preferred and common stock as follows:

	Preferred dividend	*Common dividend*	*Total income*	*Share of savings*
A	$32,000	$36,800	$68,800	$28,800
B	16,000	36,800	52,800	12,800
C	12,000	41,400	53,400	8,400
Total	$60,000	$115,000	$175,000	$ 50,000

Favoring the assets.—Professor Cole, in his "Accounts, Their Construction and Interpretation," gives a method of distributing the stock of the consolidated company which favors the company that puts in the largest amount of tangible assets. For one who has gone over very carefully the methods already described, a lengthy exposition will not be necessary. The following table will show the preliminary steps necessary in the calculation.[18]

	I *Assets*	II *Earnings*	III *Rate*	IV *Rate in excess of 10%*	V *Excess rate applied to assets*	VI *Proportion of goodwill*
A	$400,000	$40,000	10%	0%	0	0
B	200,000	40,000	20	10	$20,000	2/5
C	150,000	45,000	30	20	30,000	3/5
Total	$750,000	$125,000			$50,000	

Since *B* is contributing 2/5 of the goodwill or profit-earning power (column VI), and *C* is contributing 3/5, they will each get, respectively, 2/5 and 3/5 of the stock applicable to earnings ($500,000), that is, the capitalized earning power ($125,000 × 10) less the stock given for assets ($750,000). *B*, therefore, will receive $200,000 and *C* $300,000. This calculation has taken no account of the savings of consolidation. Very well, then, we will give *A*, *B*, and *C* for earning power or goodwill, respectively, nothing, $200,000, and $300,000. The earnings plus the savings, $125,000 plus $50,000, capitalized at 10 per cent, amount to $1,750,000. From this we take $500,000, already given to *B* and *C*, leaving $1,250,000. This will be

[18] The amounts in the columns are calculated as follows: Column III is equal to II divided by I; column IV is the difference between column III and 10 per cent; column V is I multiplied by IV; column VI is the separate items in column V divided by 50,000, the total of the column.

distributed to A, B, and C in proportion to their contributions of assets, $^{40}/_{75}$ to A, $^{20}/_{75}$ to B, and $^{15}/_{75}$ to C. The entire stock will therefore be distributed as follows:

	For earning power	*For assets*	*Total*	*Income*	*Share of savings*
A	Nothing	$666,667	$666,667	$66,667	$26,667
B	$200,000	333,333	533,333	53,333	13,333
C	300,000	250,000	550,000	55,000	10,000
Total	$500,000	$1,250,000	$1,750,000	$175,000	$50,000

Summary.—The following table is given by way of summary.

	Method I		Method II		Method III	
	Income	*Share of savings*	*Income*	*Share of savings*	*Income*	*Share of savings*
A	$72,000	$32,000	$56,667	$16,667	$40,000	Nothing
B	52,000	12,000	53,333	13,333	53,333	$13,333
C	51,000	6,000	65,000	20,000	81,667	36,667

	Method IV		Method V		Method VI		Average of All Methods	
	Income	*Share of savings*	*Income*	*Share of savings*	*Income*	*Share of savings*	*Income*	*Share of savings*
A...	$40,000	Nothing	$63,000	$28,800	$66,667	$26,667	$57,357	$17,356
B...	60,000	$20,000	52,800	12,800	53,333	13,333	54,133	14,133
C .	75,000	30,000	53,100	8,100	55,000	10,000	63,511	18,511

Explanation of methods used.—The following conditions are assumed in arriving at the results under each method:

I. Total earnings plus savings capitalized at 10 per cent, assets paid for in preferred stock and remainder of capitalization (that is, common stock) divided on basis of earnings. (See page 636.)

II. Same as I except that common stock is divided on the basis of each company's rate of earnings. (See page 638.)

III. Same as I except that common stock is divided on basis of rate of earnings in excess of a fair rate of return. (See page 638.)

IV. Same as III except that division of common stock is on the basis of the excess rate of earnings applied to the assets on which those excess earnings were earned. (See page 639.)

V. Eight per cent preferred stock given for tangible assets, and common stock given for earnings of each company capitalized on basis of 8 per cent. (See page 640.)

VI. This method is difficult to summarize. Stock is first given for earnings; the total amount of stock for this purpose is found by capitalizing earnings (net earnings plus savings) and subtracting the total of tangible assets, this difference gives the amount of stock issued for earnings and is distributed among the constituents in proportion to their excess earnings, that is, earnings above an amount sufficient to pay a fair return on the assets. Then stock is given for the assets; the total amount of this stock is the difference between the combined earnings and savings capitalized and the amount of stock given for earnings. It is divided among the constituents in proportion to their tangible assets. (See page 641.)

It will be noticed that Method I is most favorable for A and least favorable for B and C; Method III is most favorable for C; Method IV is most favorable for B; both Methods III and IV are least favorable to A. Undoubtedly a fair basis of division would be one giving stock to the constituents in amounts sufficient to enable each constituent to get the income shown in the last part of the table. As each method was explained in the foregoing discussion we gave the reason for which that method might be selected. In practice it would hardly do to attempt to make all the calculations given and then average them up. Some single method must be selected in view of the circumstances, in view of the tactical strength of the several companies, and in view, perhaps, of other elements, such as the personal force of the owners of the respective constituents.

Plan where bonds, preferred stock, and common stock are to be used.—In the illustrations given, only preferred and common stock were provided for in the financial plan. If the plan contemplated the issuance of bonds, preferred stock, and common stock, the bonds would be issued for current assets, the preferred stock for remaining assets, and the common stock for earnings. In arriving at the capitalized earnings of each of the constituents, the amount of fixed charges payable on the bonds issued to the corporations entering the consolidation, as well as the dividends on the preferred stock, will be subtracted from the earnings of each of the constituents before capitalizing the combined earnings.

Thus, assume that Company A, a constituent of a consolidation, has current assets of \$500,000, fixed assets of

$2,000,000, and average earnings of $375,000. It will receive under the plan 6 per cent bonds in the amount of $500,000, and 7 per cent preferred stock for its $2,000,000 of other assets. To arrive at the earnings of *A* to be capitalized in order to determine the common stock to which it is entitled, there must be subtracted from $375,000 the sum of $30,000 representing interest on the bonds and $140,000 representing dividends on the preferred stock, or $170,000. The net earnings to be capitalized are therefore $205,000. Assuming that earnings of all the companies, after deduction of interest and dividends on prior securities, are to be capitalized at 10 per cent, and that the total earnings of three constituents including *A*, after deduction of interest and dividends, are $650,000, the total capitalization of earnings will be $6,500,000, represented by common stock of which *A* would receive $2,050,000.

Valuation of tangible assets.—A consolidation agreement, as we have seen, will, if it is based on a scientific plan, seek to give to the constituent companies preferred stock for tangible assets and common stock for goodwill; it becomes necessary, therefore, for the agreement to provide some method by which the value of the assets will be determined. Perhaps the simplest method is to have each constituent draw up an inventory of its tangible assets and then to have the inventories checked by expert appraisers. The agreement may, however, give special directions for the appraisal of certain kinds of assets, such as patents, patterns, unfilled contracts, and the like.[19] The appraisals, together with balance sheets covering several years past, should then be given to a committee composed of one representative of each concern, with the promoter or some other disinterested person or persons as an arbiter, which committee should finally decide on the valuations of the properties. The committee may also determine, with the aid of independent auditors, and upon examination of income statements for several years past, as indicated hereafter, what is the earning power of each constituent on the basis of which its intangible properties will be valued. Sometimes the whole matter is turned over to one or more outside parties in whose ability and integrity all the constituents have implicit confidence. Thus, in the

[19] See C. W. Gerstenberg, "Materials of Corporation Finance," pages 501–2

consolidation of the International Harvester Company, J. P. Morgan was given power to appraise a large part of the assets of the constituents.[20]

Mortgaged properties.—We have seen that consolidations usually do not take over the liquid assets of the constituents. For that reason the agreement may well provide that the general debts shall not become obligations of the consolidated company but shall be paid out of the current assets retained by the constituents. But mortgages and other specific liens on the property taken over by the consolidation cannot be dismissed in this simple way. The usual method of treating mortgages on constituent properties is to provide that all assets taken over shall be paid for in preferred stock at par, but that there shall be subtracted from the preferred stock which each constituent is to receive, an amount of preferred stock equal to the amount of funded indebtedness or mortgages of the constituent, or, as seems more equitable, equal to 125 per cent, or some other rate in excess of 100 per cent, of the mortgage indebtedness.[21]

Companies with small earning power.—Each company coming into a consolidation receives preferred stock for assets —preferred as to dividends at 8 or some other rate per cent. Suppose, however, that the earnings which a given company contributes are not sufficient to pay the stipulated rate of dividends on the amount of preferred stock to be issued for assets; is it fair that the earnings of the other constituents shall be drawn upon to make up the deficiency? One way out is to provide that if the earnings of the constituent do not equal, say, 8 per cent (if that is the rate of preference), then the company shall receive in preferred stock 12½ times the amount of its earnings (12½ being the reciprocal of 8) and in common stock the remainder necessary to make up the value of its assets.[22]

Valuation of earning power.—Any one familiar with the income tax regulations knows that perplexing problems may arise in determining the income of a corporation. There is, to be sure, some difference between taxable income and

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[20] *Ibid.*, pages 499 *et seq*

[21] For an example, see C W. Gerstenberg, "Materials of Corporation Finance," pages 536–541

[22] *Ibid.*, pages 538–9 and pages 499–525

earnings. Earnings, for example, may include a gain upon an exchange of property which, under the income tax law, may be tax-free.

The chief problem of the promoter of a consolidation is to see that all companies are treated fairly. Thus the problem of what is the *income* of a corporation for income tax purposes is complicated by the question of what is a reasonable allowance to make for the salaries of the company's officers who may, at the same time, be its chief stockholders. As far as they personally are concerned, and aside from the matter of taxes, it does not make much difference whether they divide the profits as dividends or as salaries, but the effect of a division one way or the other may result in a great variation in the amount of taxes the government will receive from the aggregate of the corporation and its officers. Now, in approaching this problem from the standpoint of the promoter of a consolidation, we see that large salaries and small dividends for one constituent and small salaries and large dividends for another constituent will result in inequity in calculating the earning power of the two constituents. We simply cut the Gordian knot and provide in our agreement that all *salaries* of managers, officers, and similar higher employees (as distinguished from *wages* paid to ordinary employees) shall be added back in calculating the net earnings.

The same problem is likely to arise in connection with insurance, money actually spent for repairs, renewals and uncapitalized betterments, and arbitrary allowances for depreciation. The better plan is to provide that all items thus subtracted in the accounts of the several companies in calculating net earnings shall be added back and that there shall be uniformly subtracted for each of these purposes some percentage of the assets to which they apply: for example, 2 per cent of the plants, machinery, and so forth, for insurance; 3 per cent for depreciation; and 2 per cent for repairs, replacements, and similar items.

As previously intimated, adjustment must also be made for items of income or loss that are non-recurrent, since the capitalization is of normal operating earnings. Thus, profits such as gains on the sale of marketable securities owned by the company, profit on the sale of some fixed asset, and losses due to damage that is now covered by insurance, would be subject

to adjustment in arriving at the earning power of constituents.

Shall interest paid by the several companies be subtracted before determining the net earnings? Since, as we have seen, the constituents are required to pay back in preferred stock to the consolidated company the amount of indebtedness that stands against the property they turn over, and since they therefore are being deprived of the dividends on that preferred stock, it would seem only fair that interest on indebtedness should be deducted in arriving at net earnings.[23]

Finally, provision must be made for proper accounting methods on the part of the constituents. The rules of the Bureau of Internal Revenue on this subject may well be taken as a guide. Uniformity is usually more important than scientific accuracy.

Period over which earnings will be averaged.—In ascertaining the earning power, it would be patently absurd to choose the earnings of any one year. On the other hand, if one company is very young and the rest old, it would probably be unfair to average the earnings over a number of years, since most businesses during their early years show relatively small earnings; experiments of production, the costs of early advertising, the expense of building up a proper personnel in various departments—all these items eat into earnings in early years. Some allowance certainly must be made. Where all the companies have established records, the number of years to be averaged in determining earning power should be large enough to include a period of general business prosperity and one of general business depression.

Rate of capitalization of earnings.—The question of the rate of capitalization was discussed in Chapter XVIII. Instead of speaking of capitalization at a rate per cent, bankers have come to express the process as the purchase of profits for a certain number of years. In effect, the profits for a given number of years in the future are being purchased without discounting them to their present worth, it being assumed that the profits beyond the number of years would have little value when discounted and that this value is reflected in the purchase price by not discounting any of the years included. Moreover, the profits of the remote future

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[23] For a typical agreement covering all these points, see C. W. Gerstenberg, "Materials of Corporation Finance," pages 538–541. See also H. A. Finney, "Principles of Accounting," Vol. II, Chapter 47.

years are problematic and depend entirely upon what the new owner makes of the business during the years included in the term of the calculation. Probably the more logical method is to assume that each of the years included in the future will have profits equal to those of the last year, although as strong a case may be made out for the plan of assuming that each of the future years will have a profit equal to the average of several years in the past.

Compensation of promoter.—Under all the variations of the scientific plan discussed in the foregoing paragraphs, no allowance was made for the promoter of the consolidation. Very few consolidations of unrelated companies have taken place without the help of an outside promoter. The reasons for this are that the idea of consolidation has generally been conceived by a professional promoter and that no man is a "prophet in his own country"; the jealousies of rival concerns preclude the possibility of a satisfactory arrangement being negotiated by the manager of any one of them.[24]

What shall the professional promoter receive?—Since the scientific plan is essentially a theoretical guide, we may answer the question just propounded by giving an answer that will be but a theoretical guide. The promoter should receive in proportion to what he contributes: the savings of the consolidation. But, it may be objected, if the promoter is to receive a large part of the savings of consolidation, what advantage can be offered the constituents; how shall they better their positions by the consolidation?

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[24] Charles R. Flint is one of the best known of the promoters of consolidations, he says in his book, "Memories of an Active Life," in the chapter on "Becoming the Father of Trusts" (pages 293-6): "At this age I arrived at the fork of two roads, one of which, in the light of forty-three years of experience, I feel would have led to success—the other the road to failure. I had had no experience in forming large industrial consolidations—no one else had—and I took the wrong road. The right way would have been to give the general idea of consolidation to a *disinterested intermediary* (italics are Mr. Flint's), who as a neutral would have commanded the confidence of the manufacturers, and who would have secured all the facts necessary to formulate a plan. As a disinterested neutral he would have been able to establish intimate relations with each manufacturer and secure his acceptance of the plan." And speaking a little later of his attempt to promote a consolidation in the electrical field, one of the constituents at this time being owned by Mr. Flint, he says: "I am satisfied that a neutral could have induced Edison to join the proposed consolidation. In answer to Edison's final decision to me as a competitor—'I will not merge my prestige as an electrician with that of another'—a neutral could have offered to name the consolidation the 'Edison Corporation.' But had I made that suggestion, it would have been interpreted as an evidence of great weakness."

Several answers may be given to this question. In the first place, the constituents gain in stability of earnings; they are freed from the hazards of competition. This leads to another advantage, freedom from managerial worries on the part of the owner-managers.[25]

Moreover, the promoters of many large consolidations have caused the stocks of the consolidated company to be listed on the exchanges. Where this is done, the owners of the constituents are able gradually to convert some of their holdings into the bonds of governments, or railroads, or public utilities, and thus to free themselves from the hazards of a single investment.

In the discussion of the variations of the scientific plan of consolidation, all the savings of consolidation were distributed to the constituents; just what part of the savings will go to the promoter is a matter for negotiation.

The bargaining method of consolidation.—We must now take up another method of promoting consolidations—one that is very practical and that gives the promoter a very conspicuous place in the division of securities. In the bargaining method, the promoter estimates what the total earnings will be after the consolidation has been effected; that is, to present actual earnings he adds the savings of consolidation. The total is then capitalized at a rate that would likely make the securities of the company sell at par. He then negotiates with the various constituents, giving to each as small an amount as possible in order to leave himself a wide margin of profits to compensate him for his work. What each constituent will get will depend, of course, on the importance of the company's assets and earnings to the consolidation. The most important company will probably be dealt with first, since when it has been secured the others can more readily be forced into line. Thus, in the United States Steel Corporation, which followed this method, the Carnegie plant had to be dealt with on special terms.[26]

[25] A. S Dewing, in his "Corporate Promotions and Reorganizations," has shown that the opportunity to retire from business is frequently the bait held out to the owners of the constituent concerns by the promoters of a consolidation See the chapters on "The Starch Consolidations," and "The American Malting Company." See page 657 *post.*

[26] The reader will find a discussion of this method as applied to the United States Steel Corporation in Professor Maurice Robinson's article in the *Political Science Quarterly*, June, 1915, pages 277–300 The promotion of the United States Steel Corporation has been frequently described. See Cotter, "Authentic History of the United States Steel Corporation."

This method of consolidation, it will be realized, depends for its success upon the masterliness of the promoter. It well deserves the name of the man who employed it in one of the most conspicuous promotions among American corporations, and we may term it, therefore, the Morgan method.

The option method.—The option method differs from the bargain method in that it begins its operations with the constituents, whereas the bargain method practically begins with the consolidated company. The one makes a cake out of whatever ingredients it can obtain; the other starts with a cake and divides it amongst a number of invited guests.

In the option method the promoter proceeds from company to company and procures options on all their assets, dealing with each company separately on the best terms that can be procured. Ordinarily, the consideration that is offered is cash; that is, some consideration is given to the people controlling the property to bind an option on their stock or property, which option is to be taken up within a given time at a stipulated price in cash. After all the options are procured, the problem of raising cash is considered separately.

An example of the option method.—Just as we called the bargain method the Morgan method, so we may call the option plan the Flint plan, because the latter was so frequently and successfully used by Charles R. Flint. In his "Memories of an Active Life" he describes the option plan as applied to the formation of the United States Rubber Co. as follows [27]

> The rubber-shoe manufacturers were as ignorant as to the best way to effect a consolidation as I had been in my attempt to consolidate the electric light and power interests, and they made the same mistake that I had made. They, however, showed great patience and industry in their efforts to consolidate and at last they felt that they were on the eve of success. They met every fortnight for several months, working out the details of a consolidation The result was, as is usual in such cases, that they finally agreed to disagree.
>
> At last, in 1892, several of the rubber manufacturers interviewed me, and I conferred with them separately I told them that, if they would leave me free to bring about the consolidation, I was satisfied that I could do so within sixty days, but that I would not attempt it unless they would agree not to discuss consolidation with one another. To this they consented. Although I was not successful in dealing with the two most important companies—the Boston Rubber Shoe Company, controlled by

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[27] C. R. Flint, "Memories of an Active Life," pages 298–300.

E. S. Converse, and the Woonsocket Rubber Company, controlled by Joseph Banigan,—I was successful in bringing about the formation of the United States Rubber Company. This consolidation was very much larger than either of the two individual companies above mentioned and it ultimately absorbed them both

I did not go to see the manufacturers They saw me. They gave me their detailed statements which I treated as confidential Then I drew up a plan for the consolidation

I took options from the majority of the shareholders in each individual manufacturing company, in which options the other manufacturing companies which we expected would form part of the consolidation were not named. Instead, I provided that the options would not become operative unless the consolidation started with tangible assets to the amount of $12,000,000, so that the parties giving options fully understood that the consolidation must include important manufacturers, as tangible assets of this amount would not have been possible unless some of the large companies were included. Under this plan no manufacturing company was absolutely necessary, which materially facilitated the negotiations.

No industrial consolidation including a considerable number of important manufacturers had been brought about up to that time, and pioneering in the securing of options was difficult. I provided in the options that the tangible assets would be appraised by the Arkwright Club of Boston, the president of the Chamber of Commerce of New York, and the president of the Chase National Bank, who had been Comptroller of the Currency,—which sounded good to the manufacturers. Instead of dummy original directors, I secured men of importance, including J. Edward Simmons, who, at different times, was president of the New York Stock Exchange, New York Chamber of Commerce, and the Fourth National Bank; John I. Waterbury, president of the Manhattan Trust Company; Robert M. Galloway, president of the Merchants National Bank, and Colonel William Barbour.

Mr. Flint's experiences are so valuable to persons undertaking the organization of consolidations that we quote another from his book,[28] which, by the way, is thoroughly enjoyable reading from cover to cover.

After I had organized the United States Rubber Company, nothing succeeding like success, August Belmont asked me to endeavor to bring about a consolidation which would include the New York Belting & Packing Company, of which he was the paternal banker. To do that it was necessary for me to go West. I decided not to go unless I could start with the full confidence of all those interested in the New York Belting & Packing Company. I thought the best vote of confidence would be a full power of attorney in my favor, which I asked Belmont to give me. When it was executed, Belmont handed it to me with a "Thank God, that child's face is washed" sort of expression. To his surprise I immediately handed it back to him. With some irritation he asked· "Why do you hand the power of attorney back to me?"

[28] C. R. Flint, "Memories of an Active Life," pages 302–5.

"To possess it would prejudice me as a negotiator," I said. "If I wish to succeed I must be a *disinterested intermediary*."

I took the night train for Cleveland, accompanied by a member of the firm of Evarts, Southmayd & Choate, an expert accountant. I spent all day at the Cleveland Rubber Works, then all night on a train to Chicago, then all day investigating the Chicago Rubber Works, and then with all interested parties I went to the Auditorium Annex Hotel. Having in hand the essential facts, I then undertook to "bell the cat." I negotiated until 2 A. M., all next day and most of the next night, then part of the next day.

At the Auditorium Annex the different parties had separate rooms. In organizing it is well not to bring the interested parties together until all have been brought into agreement; for otherwise, some kind of an argument is bound to start, and once an argument gets under way so many ancient grudges pop out that the real purpose of the meeting is soon lost in a general disagreement. It is best to keep the different interests apart, confer with them separately, and hold a general meeting only when all have agreed, and, with an identity of interest are ready for a love feast. After two days and nights of negotiation in the hotel, I had brought into line everyone excepting McClymonds. He was Scotch and insisted on an extra $100,000 which, if granted, would have satisfied him and dissatisfied all the others. No one knew this better than McClymonds, but considerable hope commonly lurks in the breast of a hold-out.

With matters still unsettled, we left Chicago for New York, by way of Cleveland. McClymonds was going to get off there. When an hour from Cleveland we were no further along in our talk than we had been in Chicago. I had to name a final figure, and, having in mind the advantage of humor in a strained position, I said "McClymonds, you remind me of that Scotchman who was attacked by a footpad on London Bridge. The footpad was getting the worst of the fight when he was joined by one of his fellows. But the two together were no match for the hardy Scot, then a third came running in and turned the battle. As the trio limped away, battered and forlorn, one of them held aloft the booty.

"A sixpence," he muttered. "He'd er killed us if it had been a shilling!"

I then delivered my ultimatum, which McClymonds accepted. I had my lawyer with me, and there in the sleeping car the agreement was completed, and all signed just a few moments before the train pulled into Cleveland.

No cash passed in that consolidation. The purchase price was paid in preferred and common stock. There was no appraiser, no certified public accountant. The contract, written on the train on a single sheet of paper, was complete and conclusive.

How the cash to take up the options is raised.—Instead of actually raising all the cash called for by the options, the promoter forms a syndicate that agrees to furnish all the cash necessary, not exceeding the amount called for by the options. The consolidated company is then formed and the holders of the properties are given an opportunity to take the stock and bonds of the consolidated company instead of cash. Calcu-

lations are made to show that the cash value of the securities offered exceeds the amount of cash called for by the option. The syndicate agrees that if any of the stockholders or bondholders on whose securities options have been obtained insist upon cash payment, the syndicate will put up the cash and take in exchange for it the securities offered to the optionors. The syndicate may be given a commission of 1 or 2 per cent on the total amount involved and it will also make a profit on the securities it is compelled to take in providing cash for the optionors who insist on cash. Usually the syndicate manager will "make a market" for the various securities of the consolidated companies and in this way will be able to realize cash on the securities as soon as they are rejected by the optionors. If this can be done, the members of the syndicate may be required to put up only a small amount of initial cash, later financial requirements being provided through the market operations of the manager. By maintaining a market in this way, the manager not only relieves his syndicate members from the necessity of furnishing cash, but proves to the optionors that the representations made in respect to the securities and the excess of their value over the cash amount of the options, are actually true.

Another example of the option method.—The following brief description of a consolidation agreement will give the reader a more exact understanding of the option method In 1902 an agreement was made to form a syndicate to take up the cash options on various New Orleans public utilities that were to be consolidated. A company was to be incorporated with \$40,000,000 of 4½ per cent bonds, \$10,000,000 of 4 per cent cumulative preferred stock, and \$30,000,000 of common stock. In order to induce the optionors to take the securities instead of cash, and in order to induce bankers to join the syndicate, the following calculations and offers were made.[20]

For the year 1901 the receipts of the various companies were approximately \$3,900,000 gross, \$1,500,000 net

The increase in gross receipts should be not less than 10 per cent per annum, based upon what the properties have done in the past.

Operating expenses can be reduced by a consolidation of the power houses and shops, reduction in dead car mileage; substitution of oil as fuel, and reduction in general expenses about \$265,000 per annum.

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[20] For the complete document, see C. W. Gerstenberg, "Materials of Corporation Finance," pages 526–35

The first year of operation under consolidation, based on the report of our engineers, Messrs. Sanderson & Porter, of New York, whose letter is attached hereto, and corroborated by the above figures, should be

Gross Earnings		$4,234,000
Operating Expenses and Taxes		2,117,000
Net Earnings		$2,117,000
Interest Charges		
Existing Bonds	$630,855	
New Bonds	900,000	
Total		$1,530,855
Surplus		$ 586,145
Four per cent on $10,000,000 Cumulative Preferred Stock		400,000
Surplus for Common Stock		$186,145
For the calendar year 1903, Surplus		$719,145
Four per cent on the Cumulative Preferred Stock		400,000
Surplus for Common Stock		$319,145

The receipts for 1901 as stated above cannot be taken as a basis of what the properties will do in 1902, as the St Charles Railroad has added about 60 per cent to its track mileage, while the Gas Company and the Electric Light Company are improving and extending their plants by the expenditure of $1,000,000, which should result in a large increase of business over and above the natural increase from year to year

Subscribers (to the syndicate) are to receive a commission of 5 per cent in cash and 10 per cent in the Common Stock of the New Orleans Railways Company, one-fifth of each to be retained by the manager as compensation for managing the syndicate.

The owners of the existing securities of the companies proposed to be acquired hereunder are to be given the privilege of accepting the following securities of the New Orleans Railways Company in lieu of each $1,000 in cash to which they might be entitled·

Four and One-half Per Cent Bonds at par	$769 23
Four Per Cent Cumulative Preferred stock at par	384 61
Common Stock at par	769 23
Estimating the value of the Four and One-half Per Cent Bonds at	100
Estimating the value of the Cumulative Preferred Stock at	60
Estimating the value of the Common Stock at	15

Holders exchanging will receive about
77 per cent of the option price of their holdings in Four and One-half Per Cent Bonds,
23 per cent of the option price of their holdings in Four Per Cent Cumulative Preferred Stock;
11 per cent of the option price of their holdings in Common Stock

111 Total, showing present holders about $1,110 in value of new securities in lieu of $1,000 cash value

It will be evident that while the bonds are figured in at par, the 4 per cent preferred stock is figured in at a price to yield about 7 per cent; that is, the common stock has $319,145 available for dividends; since the issue is to be $30,000,000, and since this issue is assumed to have a value of $15 a share,

par value of $100, the principal over which the dividends will be distributed is $4,500,000, on which the available dividends will be 7 per cent. The yield on the common stock is made higher than that on the preferred because the former takes the greater risk, and for the same reason the yield on the bonds is lower than the yield on the preferred stock.

Chapter XXX

INTERCORPORATE RELATIONS THROUGH SALE OF ASSETS AND LEASES

Intercorporate relations through sale.—Instead of intercorporate relations between companies being formed by consolidation, the association may come about through sale of assets One or more companies may sell out to a company already in existence (equivalent to merger), or several companies may sell out to a new company organized to take their assets (equivalent to amalgamation). The sale is always a complete transfer of all assets, though, to be sure, it may include not all the assets of a corporation, but only all the assets relating to one branch of its business.[1] From a legal standpoint, the consummation of an association by sale of assets has several advantages over consolidation; the process is simpler and may be used where consolidation is not available, that is, between several companies organized in several different States whose laws are not favorable to interstate consolidation. Moreover, the device of sale of assets may be used for inter-business relations, such as the sale of the business of a partnership to a corporation, whereas the method of consolidation is appropriate only where all the parties are corporations.[2]

Nature of consideration, cash.—The consideration may take the form of cash, of part cash and part securities of the purchasing company, or of securities of the purchasing company.

An interesting sale for cash was that of the Harrison Paint Co. (Harrison Bros. & Co., Inc.), the business of which

[1] For an example, see C. W. Gerstenberg, "Materials of Corporation Finance," pages 511 *et seq* In 1915 Lord and Taylor, Inc, a large and old department store in New York City, sold its wholesale business to the Emery & Beers Company, and agreed to permit the purchasers to use the phrase, "successors to the wholesale business of Lord & Taylor," or "purchasers of the wholesale business of Lord & Taylor," for a period of two years.—*New York Times*, December 30, 1915.

[2] For an example, see C. W. Gerstenberg, "Materials of Corporation Finance," page 499.

dates back to 1793, to the du Pont interests which organized a new company known as "Harrisons, Inc." to take over the assets. The consideration was said to be $5,700,000 in cash, sufficient to pay about $200 a share. Corporate history has known many other instances. On March 16, 1917, the stockholders of the Tamarack Mining Co. voted to sell their assets to Calumet & Hecla Mining Co. for $3,600,000, or $60 a share.

Where cash is given, the value of the purchasing company's stock need not be inquired into. This, of course, is an advantage. Moreover, the cash payment generally is more attractive than a stock payment. However, from the standpoint of the purchasing company there is the difficulty of raising the cash.[3]

Consideration, partly cash.—Sometimes securities of the purchasing company are offered as part consideration to accompany a cash payment. The cash payment may be made either to induce the selling company's stockholders to make the exchange, or the stock may be offered (usually a cumulative preferred stock) to reduce the amount of cash required to be paid by the purchasing company to the owners of the vendor company, who are probably anxious to retire from business. An example was the sale of the Boston Belting Co. in 1917 to the Roxbury Carpet Co.; the consideration for each share of the belting company's outstanding stock was $82.50 cash and $50 in 6 per cent cumulative preferred stock of a new company formed to take over the assets.

Sale for securities of the purchasing company.—Frequently, the sale is made for the securities of the purchasing company. In such a case the shares received may be held by the selling company, in which event it becomes a holding company; or the shares when received may be distributed to the shareholders of the selling company, whereupon the latter company is dissolved. In this latter case the sale will have effected a merger. Sometimes, though the selling company practically ceases to exist, its name may be retained for selling purposes Thus in May, 1918, the General Motors Corporation purchased all the Chevrolet Motor Co. assets (with the exception of the latter company's holdings of the former company's stock) for enough common stock of the

[3] See page 317.

General Motors Corporation to give Chevrolet a total holding of General Motors equivalent to one-seventeenth of its own stock. Thereupon each stockholder of the Chevrolet company received in General Motors stock, shares equal to one-seventeenth of their respective holdings, and the Chevrolet company was completely liquidated, "but the company will constitute and will be known as the Chevrolet branch of the General Motors Corporation." In much the same way the United States Leather Co , when it was completely taken over by the Central Leather Co., was maintained, on account of the value of its name, as a selling organization with a *nominal capital* stock of $100,000.[4]

Sale of assets as a means of diversifying investment of owners.—In recent years many successful, individually owned businesses and closely held corporations have sold out their entire assets, with the aid of investment bankers, to a new corporation capitalized on the basis of the earning power of the selling company, in exchange for cash or cash and stock of the new company. The funds required to pay the original owners for their interests, where compensation is made in cash, are raised through the sale of stock of the new company to the public. The effect of such a transaction is to permit those who have their capital invested in one enterprise, to diversify their holdings by investing in various securities the funds received in payment for their interests in the old corporation. The original owners may retire from the management of the new business, or they may continue in active control by retaining a majority of its voting stock. Frequently, in sales of this kind, the investment bankers will not carry through the deal unless those responsible for the success of the original company will enter into contracts agreeing to administer the affairs of the new company for a definite period. An incidental advantage of the change from a closely held corporation to one with shares widely distributed is the creation of a more active interest in the company on the part of the public.

During the favorable securities market of 1927, 1928, and part of 1929, investment bankers were eagerly seeking small successful enterprises that could be converted into larger corporations in the manner described, or by amalgamation

[4] A. S. Dewing, "Corporate Promotions and Reorganizations," page 27, note.

with other small or large corporations. The investment banker, as promoter of such a deal, created a supply of securities to offer to his clients and made a promoter's profit as well as a profit on the sale of the securities.

Sale of assets as method of changing names.—Some years ago a member of a partnership that had been incorporated applied to the author to change the name of the corporation since an old partner had retired from the corporate business under circumstances that made the inclusion of his name in that of the corporation anything but an asset. It was decided, from all standpoints, that it would be far better and simpler to incorporate a new company dropping the recalcitrant partner's name, and to sell the old company's assets to this new company, than to take advantage of the means that are offered by the corporation statute for changing a corporate name.

Sale as a means of reincorporation.—The American Woolen Co., prior to 1916, was a New Jersey corporation most of whose assets were in Massachusetts. This situation was bad from the standpoint of taxes and it was decided to move the company legally to Massachusetts and thus get rid of the New Jersey taxes. A Massachusetts company was formed and the assets of the old New Jersey company were sold to it. A number of corporations have reincorporated in other States in this way. In 1923 the United Light & Power Company was organized as a Maryland corporation to acquire all the holdings of the United Light & Railways Co., a Maine corporation. By this change the inheritance tax liability of holders of stock in the company was reduced, for the State of Maryland did not tax the transfer of shares in a Maryland corporation held by a non-resident, while the State of Maine at that time did.[5]

Sale as recapitalization.—A sale may be resorted to as a means of recapitalizing a business.[5a] An example is contained in the following quotation:[6]

It was announced from Cleveland, Ohio, on January 15, 1915, that plans for a reorganization and drastic reduction in capital of the Bishop-Babcock-Becker Co. were announced by a communication received by shareholders,

[5] See page 89.

[5a] Sales of assets frequently take place in connection with foreclosure proceedings. See chapter on Reconstruction of Corporations.

[6] From Standard Statistics Service.

signed by a committee composed of Howard W Yoemans, E. S. Griffiths and John Sherwin, who were designated by the directors to formulate the plan Shareholders were given until January 25, 1915, to deposit their stock with the First Trust & Savings Bank The present capital included $3,965,700 preferred and $3,367,300 common stock outstanding The new capital will include $3,000,000 preferred, cumulative after January 1, 1916, at 7 per cent, and $1,000,000 of common. The preferred shareholders will receive seven shares of new preferred and one share of common for each ten shares of old preferred held This will take up $2,775,990 of the new preferred and leave $224,010 of that stock unissued. It will also take up $396,570 of common. Common shareholders are to receive one share for ten This will take up $336,730 and will leave $266,700 unissued The reorganization takes the form of the sale of all the property and assets of the old company to the new, for the securities of the new company, after which the exchange of the old stock will be made at the ratio named The undistributed securities are to be subject to sale, with preferential rights to the shareholders It was stated that the company was then free from debt.

Simplicity of sales of assets.—Under the common law, a company ordinarily cannot sell out all its assets without the consent of its stockholders.[7] But in most States the question is regulated by statutes. We may take the essential features of the New York statutes as a fair example of the legal steps required, and in order to bring out the advantages of the sale of assets over consolidation proceedings we shall arrange the steps of both methods in parallel columns.

Consolidation	*Sale of Assets*
1. Action favorable to the proposed transaction by boards of directors of both companies	1. Same as in consolidation.
2 Meeting of stockholders of both companies	2. Meeting of stockholders of selling company only.
3 Written consents of holders of two-thirds of stock of both companies.	3 Stockholders holding two-thirds of selling company's stock must consent.
4 Agreement of consolidation with written consents filed in office of Secretary of State and in county clerk's office.	4. Selling company delivers deeds and bills of sale to purchasing company.

[7] This rule is subject to various provisions and exemptions which it would be out of place to discuss here. See W. C Noyes, "Intercorporate Relations," Chapters XI-XIV.

Consolidation	*Sale of Assets*
5. Exchange of stock of consolidated company for that of constituents.	5. Exchange of stock or cash of purchasing company for assets of selling company. Selling company distributes acquired stock or cash and is dissolved. Or the selling company may exchange the acquired stock for its own stock and then turn over its own stock to the purchaser, thus becoming a subsidiary company of the latter.[8]
6. Disgruntled minority stockholders in both companies may have their stock appraised and compel the consolidation to buy out their interests for cash at appraised value.	6. Same as consolidation, but as to the selling company only.

Since, as is stated above, the process of sale of assets has certain advantages over the legal process of consolidation in that it does not require the consent of the stockholders of both corporations, it is evident that in practice the sale-of-assets method is likely to be used more frequently than the consolidation method.

Financial arrangements in intercorporate relations by sales. When a sale is made for stock, so far as the stockholders are concerned the distribution, if worked out on a scientific basis—as distinguished from the bargaining or the option methods[9]—should be planned along the same lines as those outlined for consolidation. A concrete example will make this clear.

COMPANY *B* SELLS TO COMPANY *A*

A		*B*	
Tangible assets	$ 200,000	Tangible assets	$100,000
Excess of capitalized earnings over assets	300,000	Excess of capitalized earnings over assets	400,000
Authorized stock	2,000,000		
Outstanding	1,000,000		
To be issued to *B*	500,000		
Unissued	500,000		

A proposal is made to sell all the assets of *B* to *A* in exchange for some of *A*'s stock. It may seem fair, at first thought, to apply the principles of appraisal and distribution

[8] This latter method also preserves the name of the selling company.

[9] See pages 633 *et seq.*

described under consolidation[10] to company B and then to let A pay B with its stock to the amount that an appraisal would show to be due. Under the facts assumed, this would amount to \$500,000. This procedure would give to B one-third of A's outstanding stock. But has not A contributed, according to an appraisal of both companies on a scientific plan, only one-half the assets of the joint enterprise? It would seem that A's assets, tangible and intangible, were actually worth only \$500,000, but that \$1,000,000 par value of stock had been issued for them. Clearly A's stock has been watered. The fusion of the two companies may insure certain economies and result in savings large enough to warrant an issue of stock of \$1,000,000 for each company.[11]

But at any rate our problem shows that the selling company cannot be treated equitably unless the tangible assets and earnings of the purchaser, as well as those of the seller, are appraised. In other words, the relative interests of both companies in the total capitalization are more important than the absolute amount of stock which the seller receives. In short, as far as the organizers of the intercorporate relations are concerned, the agreements for the distribution of securities will be reached in the same way, whether, subsequently or previously, the legal details are worked out on the basis of a consolidation or on the basis of a sale of assets. To make this clear to students the author sometimes uses this homely analogy. A has a binful of wheat, B a binful of corn, and C a binful of oats. The bins are to be mixed into bin X, and A, B, and C are to get their shares of the mixture. Two problems are involved: first, how will the wheat, corn, and oats be conveyed to X, and second, what share of the mixture will A, B, and C each get, remembering that a bushel of wheat, one of corn, and one of oats do not have the same value. The conveyance may be made by shovels, wheelbarrow, and so on; that is the counterpart of the legal phase of the intercorporate relations problem. The division of the mixture, a much more intricate and interesting problem, is similar to the division of securities. The latter problem, the division

[10] See pages 643 *et seq.*

[11] If the stock of A is all common stock, it may be fair to issue to B \$1,000,000 of A's common stock. If A's stock is part preferred and part common, the fair distribution would give to the stockholders of each company preferred stock for tangible assets and common stock for goodwill.

of the mixture, can be worked out on quite scientific lines no matter what methods of conveyance have been used

An illustration of sale of assets.—An illustration of the principles set forth in the foregoing paragraph was furnished by the sale, late in 1917, of the assets of the Nipe Bay Co., a sugar producing company, to the United Fruit Co. On November 20, 1917, a letter was sent to the stockholders of the Nipe Bay Co. (about 66 per cent of the stock was held by the United Fruit Co.) asking them to consent to the sale of all the assets of their company to the United Fruit Co In order to show that the offer was equitable, the balance sheets of both companies were submitted as follows:

Assets	*United Fruit Co and Subsidiaries*	*Nipe Bay Co and Subsidiaries*
Plant and equipment	$53,962,825	$12,221,068
Steamships	13,957,677	.
Investments	7,230,947	141,688
U S Government & English loans	4,341,695	
Planters' loans	662,681	...
Notes receivable	41,500	...
Coupon dividend and trustee account	715,516	1,737
Cash on hand.	7,444,941	821,411
Cash for redemption of 5% notes	10,000,000	
Current assets	11,862,514	640,176
Total	$110,220,296	$13,826,380
Liabilities		
Capital stock	$48,792,400	$4,502,500
4½% debentures	5,750,000	
5% serial debentures	160,000	.
5% 4-year notes	10,000,000	
5% first mortgage bonds..	. .	3,500,000
Subsidiaries' obligations	1,732,080	31,675
United Fruit Co advances	. .	2,196,844
Current liabilities	4,685,234	394,985
Interest and rental accrued	349,272	72,917
Notes, dividends, coupons payable.	51,048	29,377
Costa Rica Ry. material reserve.	248,125	.
Steamship construction reserve	4,370,286	...
Tax reserve..	3,733,729	221,438
War emergency reserve ..	5,000,000	.. .
Surplus.	25 353,119	2,876,643
Total...	$110,220,296	$13,826,380

The United Fruit Co.'s stock, it will be seen, has a book value of $151.96 a share (add surplus to capital and divide by the number of shares, that is, by 487,924), while that of

the Nipe Bay Co. has a book value of $163.91. If, however, we consider the ample reserves of the United Fruit Co., and consider that the stability of the dividends of the Nipe Co. (8 per cent in each case) will be better assured by resting on the wide interests of the United Fruit Co. instead of resting on the profits of the sugar business only, it will not seem surprising that the outstanding stockholders of the Nipe Bay Co. unanimously consented to an exchange of their stock on the basis of dollar for dollar.

Rights of creditors.—The only creditors with whom we need concern ourselves are those of the selling company, for unless there is some fraud in overvaluing the properties of the selling company and in issuing for such overvaluations preferred claims on the purchasing company, the creditors of the latter are not affected.

In the first place, specific liens on the property of the selling company will not be displaced. At the same time the after-acquired clauses in the mortgages of the selling company become inoperative, for property acquired by the purchasing company cannot be said to be after-acquired property of the selling company under the terms of the latter's mortgages.[12]

As a general rule, the purchasing corporation will not be liable for the debts of the selling corporation unless: (1) there is an agreement, express or implied, to assume the debts of the selling corporation; (2) the circumstances surrounding the transaction show that there was a consolidation or merger, in which case the rules as to liability for debts of constituent companies would be applied;[13] (3) the purchasing corporation is found to be a mere continuation of the selling company; (4) the transaction is fraudulent; (5) a statute requires notice to creditors and the statute has not been followed.

If the selling company receives money to pay its debts, its creditors cannot subject the property in the hands of the purchaser to the payment of their claims, provided the purchaser is not liable for reasons mentioned under the general rule.

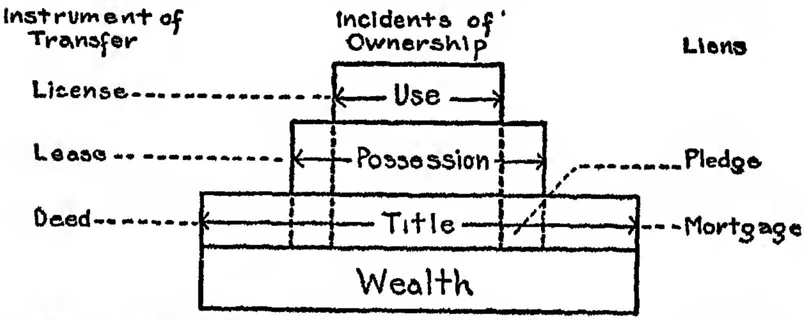
If the selling company remains in existence as a holding company, holding the stock of the purchasing company which

[12] This is generally the rule, though the selling company's mortgage might conceivably be so worded as to change this general rule. Fidelity Trust Co. v. Staten Island Trust Co., (1905) (N. J. Ch.) 67 Atlantic 1078.

[13] See page 630.

the latter paid for the assets of the selling company, the general creditors of the selling company will undoubtedly have to look to this stock for the payment of their debts, though under the Bulk Sales Acts of many States, the corporations will be compelled to prove that their inter-transactions were not fraudulent. If the selling company, as a part of the whole scheme, distributed the stock of the purchasing company among its stockholders and went out of business, the purchasing company would be regarded as agreeing to pay the selling company's debts and the assets it received would have to be used for that purpose if necessary.

What is a lease?—Having discussed intercorporate relations formed through the sale of all the assets of one or more companies, we may now turn to leases. The incidents of



Pledge transfers possession as well as title, whereas mortgage conveys legal title without possession.

Diagram Showing Relation of Instruments of Transfer to Incidents of Ownership

ownership of property and the instruments used to convey them may be roughly indicated in the above diagram, it being noted that each incident includes ownership of a lower degree.

A sale by deed transfers title or complete ownership which includes possession and the right to use; a lease transfers possession, and a license yields the right to use [14]

A lease, then, is an instrument giving the right to possession of property to a tenant or lessee in exchange for rent to be paid to the landlord or lessor.

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[14] Licenses might be included in intercorporate relations, but since they are used generally only by railroad companies in what are known as traffic agreements, we shall not consider them here

Rent.—Corporate leases of the entire assets of a company usually include every form of tangible and intangible property, the possession and use of which are turned over to the lessee in exchange (1) for payment of all the lessor's debts, such as taxes, salaries of officers, rent of offices, (2) for interest on the lessor's bonds, and (3) for a stipulated compensation which may be, (*a*) a flat annual sum,[15] (*b*) a proportion of the gross revenue,[16] (*c*) a proportion of the net earnings, or (*d*) a stipulated rate of dividends on the lessor's stock which in practice is usually paid directly to the lessor's stockholders by the lessee.

Usually, whatever is the measure of the rent, at least some debt is created; that is, even if the lessee is to pay no dividends on the stock of the lessor unless they are earned, or if the rent is to be a percentage of the earnings, the lessee will at least agree to pay the interest on the lessor's bonds; however, even this amount of rent is sometimes not guaranteed, as in the case of the lease of the Mason City & Ft. Dodge R. R. Co. to the Chicago & Great Western. The latter company, in this case, merely agrees to apply the net earnings to the former's bonds. It would hardly seem as though this were a lease at all; the arrangement might well be called an operating agreement.[17]

Since the lessor will usually have no income of its own, and since it is necessary that its corporate organization be kept

[15] An example is the lease of the Western & Atlantic R. R. made by the State of Georgia to the Nashville, Chattanooga & St. Louis Ry. Co. and dated to take effect as a renewal December 27, 1919. The lessee is to pay $15,000 a month and to spend $60,000 a year on improvements. The road was built by the State between 1841 and 1850. Another example is the 99-year lease of the 303 miles of railroad of the Georgia R. R. & Banking Co. to the Louisville & Nashville R. R. and the Atlantic Coast Line for $600,000 a year.

[16] Thus the lease of 1878 made by the Keokuk and Des Moines Ry. Co. to the Chicago, Rock Island & Pacific R. R. Co., provided for interest on the former's bonds and 25 per cent of the gross earnings. Sometimes in cases like this a minimum and a maximum payment are stipulated. Thus the lease of the Lehigh and Susquehanna R. R. to the Central of New Jersey (1871) provides for a rental equivalent to one-third of the gross receipts with a guaranteed minimum rental of $1,414,000 and a maximum of $2,043,000, plus one-third of the gross receipts until such one-third amounts to an additional 7 per cent of the money expended by the lessor since December 31, 1882, in improving and extending its leased property.

[17] The arrangement in full is not so one-sided as may appear from the statement in the text. The smaller road has a great deal of interchange of traffic with the larger road, and the lease provides that the lessor shall receive not less than 60 per cent of the total revenue from traffic interchanged between the lessor and lessee.

alive (1) to protect the corporate franchise, (2) to see that the terms of the lease are being kept, and (3) to provide an official representation of the stockholders of the lessor in negotiations touching upon contemplated changes in the lease or upon matters of financing additions and the like, it is customary for the lessee to pay in addition to other rent some sum for "organization expenses," varying from $500 per year (lease of the European & North American Ry. to Maine Central, 1882) upwards.

Leases of mining property are frequently made, and the clauses pertaining to rent usually provide that the lessee shall spend a certain amount of money per year for development purposes and shall pay to the lessor a certain sum per unit of ore taken from the ground. Thus the Tennessee Copper Co. has a lease on property in Polk County, Tennessee, the consideration for which is a royalty of $7.50 per ton of pure metallic copper produced from the ore and 15 cents per ton for all iron ore or other minerals sold from the leased land. Another arrangement, which is hardly to be recommended unless the lessee has demonstrated efficiency in its production methods, is to divide the net profits. Thus the Anaconda Copper Mining Co. pays to the Butte Copper & Zinc Co. one-half of the net profits derived from working the latter company's properties.

Extra guarantees may be given to assure the payment of the stipulated rental. The $600,000 of rental to be paid annually to the Georgia R. R. & Banking Co. by the Louisville & Nashville and the Atlantic Coast Line is secured by the deposit with a trustee—the former Farmers Loan and Trust Co.—of various bonds with an aggregate par value of $1,075,000. Under a lease made in 1901, for 999 years, between the Pittsburgh, Bessemer & Lake Erie R. R. Co., lessor, and the Bessemer & Lake Erie R. R. Co., lessee, the lessee agrees to pay the interest on the lessor's bonds, 6 per cent dividends on the preferred stock, and 3 per cent on the common stock, and these payments are guaranteed by the Carnegie Steel Co., which controls the lessee through stock ownership.

Disadvantage of complicated rentals.—Some simple form of rent is always to be recommended in preference to complicated schemes of rent payments, since the latter are apt to invite litigation. A good example of a complicated scheme is the lease made in 1868 between the Morris & Essex R. R.,

lessor, and the Delaware, Lackawanna & Western R. R., lessee, under the terms of which the lessee was to pay the interest on the lessor's bonds and 7 per cent on the lessor's stock. There was a provision, however, that if 30 per cent of the gross revenues received from the leased property was in excess of the amount needed to pay interest on the lessor's indebtedness plus 10 per cent on the lessor's stock, then the lessor was to receive an extra 1 per cent on its stock. A controversy arose over the question of whether the Delaware, Lackawanna & Western was keeping its accounts improperly and was charging to the capital account the costs of certain changes which were not included under the lease among the expenditures which the lessor could be required to pay for. The result, so the lessor claimed, was a wrongful increase in his capital indebtedness, which increase caused the 30 per cent of the gross revenues mentioned in the lease to fall below the amount required for interest plus 10 per cent dividends on the stock. Thus the dividends were kept at 7 per cent instead of being increased to 8 per cent. The suit was finally settled by modifying the lease to make the rental a flat 7¾ per cent per annum, instead of the old 7 per cent rate with a contingent 8 per cent rate. The agreement of settlement also provided that the Lackawanna would not capitalize, by causing the Morris & Essex to issue bonds against them, improvements amounting to about $11,000,000 made upon the Morris & Essex from 1899 to the date of the agreement.

The lesson of this episode is, if a lease provides for rental proportioned in any way to earnings, gross or net, or provides for the payment of certain kinds of expenditures by one or other of the two parties, the lease itself should be very clear in its definition of financial and accounting terms.

The effect of a lease.—The usual effect of a lease, we have seen, is to make the lessee or tenant the active operating agent of the *property*—not of the lessor—and to give to the stockholders of the lessor, in exchange for their erstwhile more or less speculative interest in the profits of operation, a stipulated rate of income which is a debt against the lessee.

Who can make the lease.—As in the case of intercorporate relations by sale of assets, the recipient of the property may take the property without getting the consent of its stockholders. That point seems quite evident. But the question of the rights of a stockholder of the prospective lessor is not

quite so clear. To be sure, the question is frequently decided by statutes, and in their absence the following rules would seem to obtain: Except as a step toward liquidation (when the majority may lease for a reasonable time), the unanimous consent of the stockholders is necessary, because (1) every stockholder can insist upon having the corporate property managed by the corporation's own officers; (2) every stockholder is entitled to participate in dictating the broad policy of the corporation; (3) every stockholder is entitled to receive a share of profits in proportion to the prosperity of the company and cannot be compelled to accept a fixed rental [18]

Rights of creditors.—A tenant is not bound to pay the debts of the landlord, but a corporation cannot turn its property over without taking care of its creditors. The ordinary procedure is for the tenant to agree to pay the landlord's debts; this procedure prevents a disruption of the property or an interference with the lease by the landlord's creditors. Of course, all debts arising out of the operation of the property after the lease becomes effective are debts that belong solely to the tenant, and these include such debts as those arising from the negligent use of the property.

The tenant, likewise, agrees to pay the taxes, failure to do which not only injures the landlord but the tenant as well, since the property may be seized by the State for taxes in arrears.

Advantages of lease.—Intercorporate leases have been used chiefly by railroads, and in that field they have presented certain distinct advantages From the standpoint of the lessor, the lease gives the stockholders a certain guaranty of a fixed return and changes the nature of their claim from that of a stockholder to that of a bondholder. Their claim is that of a debt against the lessee, which debt if not paid will result in the lessee's loss of the property. In this sense, then, the debt is a fixed charge of the lessee, and, indeed, under the rules of accounting of the Interstate Commerce Commission, is grouped with the bonded interest of the tenant in its income statement.[19]

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[18] W. C. Noyes, "Intercorporate Relations," Chapter XV. In New York the highest court has held that directors may dispose of property by lease, but this would seem to be incorrect on principle. Beveridge v N. Y. Elev R. Co., (1889) 112 N. Y. 1.

[19] See, for example, the income statement of the New York, New Haven & Hartford R R. in C. W. Gerstenberg, "Materials of Corporation Finance,"

From the standpoint of the lessee, the lease gives the company control of property, usually of great strategic value, which could not be acquired in any other way. Thus, in 1868 the Delaware, Lackawanna & Western obtained a lease of the property of the Morris & Essex, which property has been likened to the neck of a bottle emptying the traffic of the former company's road into the great seaport of New York.

In general, the lease provides a simple method of forming intercorporate relations which does not require the issuing of any securities or the raising of any funds.

Another advantage of the lease form of combination is that the lease may become valuable and yield a profit to the corporation upon a sale or assignment thereof. A combination effected by a lease has the further advantage of being easily dismantled if the arrangement proves unprofitable. At the expiration of the lease, the leased property is simply returned to the lessor. To be sure, if the lessee has acquired a controlling interest in the lessor through stock ownership, the dismantling may involve a sale of the stock upon the reversion of the leased property to the lessor.

Leases for special purposes.—A lease may sometimes perform a function that could not very well be performed by any other device. Thus, the Public Service Co. of Illinois provided the population in the territory surrounding Chicago with gas and electricity. The confines of Chicago were expanded to take in some of this territory. By law the rates for gas and electricity within the city limits were lower than they were outside the limits—lower indeed than the Public Service Co. could afford. It therefore simply leased that

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page 667 It is interesting to note that if company *A* wishes to control company *B*, it may do so by lease, or by acquiring the stock of company *B* and issuing to the stockholders of company *B* in place of their stock, collateral trust bonds secured by the acquired stock This was the method followed, for example, by the Rock Island Railroad, a non-operating company, in getting control of the stock of the Rock Island Railway (W. Z Ripley, "Railroads, Finance and Organization," page 527) In the one case rent is to be paid for a lease; in the other interest is to be paid on collateral trust bonds. In the one case the original stockholders of the controlled property retain their stock; in the other they exchange them for bonds secured by that stock It would seem that the lease is a better arrangement, since if the controlling company does not meet its obligation, the lease can simply be declared broken and the property recovered, while in the case of the collateral trust bonds, the pledged stock will have to be recovered through foreclosure proceedings, unless, of course, the debtor company agrees to a voluntary release.

part of its distributing systems to utilities regularly supplying the city at the lower rates.[20]

Another illustration of an extraordinary situation solved by a lease is that of a lease to a Texas company of all the properties of the Missouri, Kansas & Texas of Kansas lying within the State of Texas, in compliance with an agreement with the State of Texas looking to the enforcement of its statutes prohibiting the control of railroad property within the State of Texas by other than Texas corporations.

Flexibility of leases.—A great many leases, especially of railroad properties, are made for very long periods, say 999 years. Where the rental is fixed in such long leases, injustice may be done to one party or to the other. Thus, without fault on the part of the lessee, the earnings may diminish to an amount less than the rentals. A parent may get rid of a burdensome subsidiary, but the burden of a lease is a contractual obligation that cannot readily be set aside.

On the other hand, conditions may change as they did during the war, and the fixed rental may, to the injury of the lessor, lose its purchasing power.

It would seem to be better, therefore, to make the term of the lease rather short and to make, if desired, some provision for renewals on an adjusted basis. Thus, in 1919, when the State of Georgia renewed its lease of the Western & Atlantic R. R to the Nashville, Chattanooga & St. Louis R. R., it excluded from the new lease certain buildings which yield a rent of about $15,000 a year, and increased its rents on the rest of the property from $35,000 to $40,000 a month.

Oil leases and royalty interests.—Oil companies generally do not acquire oil lands outright, but obtain the right to prospect and drill for oil upon the land and to produce oil and gas when they are found. This right is given to the company in an oil lease. Usually the company agrees to pay a cash rental of a certain amount per acre per year until oil or gas is produced; thereafter it must deliver to the lessor one-eighth of all the oil and gas produced from the leased premises. The lessor's right to part of the oil and gas produced from the land is known as a "oil royalty" interest.[21] The entire cost

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[20] In re Public Service Co, P. U R 1915 (B), pages 358 and 870.

[21] An oil royalty interest has a value and may be bought and sold like stocks and bonds. Certain oil or gas interests are included in the definition of

of drilling and producing is borne by the lessee; the only cost to the lessor is usually a production tax paid to the State Actually the part of the oil belonging to the owner of the oil royalty is not delivered to him. All of the mineral produced is sold to the pipe line company of the district, which pays the producing company for seven-eighths of the total production and the royalty owner for one-eighth

Disadvantages of the lease.—Why is the lease not used more generally? In the first place, the maintenance of the lessor company as a separate entity means additional taxes and duplicate reports to governmental bodies. In the second place, it establishes a relation of somewhat "unstable equilibrium," to borrow a phrase from physics. There is always the problem of *meum* and *tuum*. Instead of a single interest in the property, there are always two interests to be considered—that of the tenant, and the ultimate interest of the landlord in the reversion of the possession. If the lease is not very carefully drawn, litigation is invited and the development of the property is retarded by the uncertainties regarding mutual rights and liabilities. Moreover, unless the lease provides some equitable method of financing additions and improvements, these will probably not be undertaken by the tenant without compensation, since the possession and title to them will revert to the landlord on the termination of the lease.

In the public utility field the leasehold structure of intercorporate relations has complicated the financing of growing organizations and attempts have been made by some companies which originally acquired local producing companies upon long term leases to get rid of the leases and acquire title to the plants through the merger of the subsidiary lessor companies with the lessee or some company owned by the lessee. This change can be attempted only where the lessee has acquired a controlling interest in the stock of the lessor company. The Public Service Corporation of New Jersey, for example, has pursued a policy of substituting ownership for leases in this way.

Another disadvantage of the lease arises out of the tax problem. If the lessor company's assets were completely

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"security" under the Securities Act of 1933 To facilitate the sale of the royalty interest, it may be split up into separate units, each part being entitled to its proportionate part of the royalty income from the entire leasehold.

taken over by the lessee company and the lessor dissolved, it would not have to pay State franchise taxes. Moreover, the rent paid to the lessor, even if the lease provides that it is to be paid directly to its stockholders, is considered under the Federal Income Tax Law to be taxable income on which the corporation tax must be paid. However, if instead of the lease a stockholding arrangement were made, the tax would be avoided. For example, the lessor's stockholders might give up their stock to the lessee in exchange for collateral trust bonds of the lessee secured by the stock thus given up. Interest on the bonds would be an item deductible from the lessee's taxable income, just as was the rent, but the lessor company would not have any taxable income whatever.

Financing additions and improvements.—Under the common law of leases, any additions or improvements affixed to the property by the tenant become the property of the landlord at the expiration of the lease. Thus it would seem that in the absence of a special provision in the lease, such improvements as the electrification of a leased steam railroad would only temporarily benefit the company that paid for them—the lessee—and would finally at the expiration of the lease belong, without compensation, to the landlord. This was just the situation in respect to many old leases. From one standpoint this apparent injustice would not seem to bear heavily on the lessee. The lease, we may say, is for 999 years, and a given improvement costing $1,000,000 is contemplated. Shall the fact that in 999 years the $1,000,000 is to be turned over to the landlord, deter the lessee from making improvements? What will be the value of a present investment of $1,000,000 a thousand years from now? The lessee would have to earn each year only a very small sum above the interest on the $1,000,000 to accumulate a sum of $1,000,000 one thousand years hence.

But there is always the hazard of losing the property before the expiration of the contract period. The lessee may run into hard times, find it impossible to pay the rental, and have to give up the property. The risk is too great. And, moreover, there is a bit of psychology involved. Why put money into other people's property?

One way out—an old way—is to provide that at the termination of the lease the landlord shall reimburse the tenant for the then value of the improvements placed on the property

by the tenant. But this arrangement leads to various perplexities, such as the difference in the purchasing power of money at the time of making the improvements and at the time of the maturity of the lease. Moreover, the lease would undoubtedly provide that the payment would have to be made only at the due date named in the lease and not at the date of returning the property to the landlord, if this were done sooner for failure to pay rent.[22]

The modern method of financing such improvements is to cause the landlord company to pay for them with its own securities. This method is eminently fair, for as long as the lessee uses the improvements, it pays rent for them by paying the interest on the landlord's bonds or the dividends on the stock that was issued to pay for the property, whereas the permanent ownership and the capital obligation both belong to the landlord.

Concrete example of financing under a lease.—In the lease of the West End Street Railway Co. to the Boston Elevated Co.,[23] the financing of improvements was to be handled as follows.[24] The lessee decides on a given improvement, it asks the landlord's consent and if this is refused, an arbitral board passes on the question of whether the improvements are warranted. Assuming now that the improvement is to be made, the lessee makes the improvement and the expense is borne by the issuance of bonds or stock of the lessor. The lease provided that:

> The Lessee shall in all cases have authority as between the parties to decide whether stock or bonds, or both, and what amount thereof, shall from time to time be issued, and shall also have the right to determine the rate of interest upon all interest-bearing obligations, and the time for which they shall run, whether the same are issued for the purpose of refunding or paying indebtedness or for the purpose of paying for permanent additions, alterations, or improvements to or upon the demised property, provided, however, that no bonds shall be issued in excess of the outstanding capital stock of the Lessor, that no bonds shall be issued to become payable after the expiration of this lease without the consent of the Lessor; that all bonds shall be payable in lawful money of the United States, unless, in the case of bonds issued to refund gold bonds of the Lessor already outstanding,

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[22] See testimony of Lewis Cass Ledyard, in re lease of Worcester, Nashua & Rochester R. R., Investigation of Financial Transactions of the N. Y., N. H. & H. R. R. Vol. I (Senate Doc. 543, 62nd Congress), page 1104.

[23] The entire lease is given in C. W. Gerstenberg, "Materials of Corporation Finance," pages 555 *et seq.*

[24] The lease ran for twenty-four years from 1897.

the parties shall otherwise agree; that no such bonds shall be sold at less than par, and that the benefit of all reductions in interest shall accrue to the Lessee. All stock issued as provided in this article shall from the time of such issue be deemed part of the Lessor's capital stock within the provisions of Clause 3 of Article I of this Indenture (relating to dividends to be paid by Lessee on Lessor's stock), and all bonds so issued shall be scheduled and the interest paid as part of the Lessor's indebtedness under and pursuant to Clause 2 of Article I.

Since the entire cost of a given piece of work on the leased property will fall on the lessee if that work is properly chargeable to operating expenses, while, if properly chargeable to capital, it will be divided between the lessee and the lessor, it becomes quite necessary that the lease shall specify clearly what are permanent improvements, additions, and so forth, properly chargeable to capital and for the cost of which the lessee may call upon the lessor to issue its securities. The question was covered in the West End lease in the following language:

Permanent additions, alterations and improvements for which the lessor may be called upon to pay under the provisions of this lease shall consist of.

(1) The abolition of grade crossings

(2) Additional rolling stock and its equipment.

(3) Additional track mileage and its equipment.

(4) Additional real estate.

(5) Additional stations, additional power-houses with their equipments, and additional car-houses with their equipments.

(6) Additional bridges, buildings and other structures.

(7) Renewals of or substitutions for stations, bridges, buildings and other structures, tracks and equipment, rolling stock and equipment, power-houses and equipment, and car-houses and equipment, so far as the cost of such renewals or substitutions exceeds the cost, when new, of the things renewed or the things replaced.

Maintenance of leased properties.—The common law of leases provides that the tenant must make repairs. But in corporate leases involving large and valuable properties the maintenance of the property is specially provided for. The tenant is required to keep the property properly and adequately repaired (some of the older leases naively provided that the tenant was not to "make any discrimination" between its own property and that of its landlords), to keep it properly insured, and to permit the landlord's officers to make tours of inspection.

Manipulation of leased premises.—Leases must be carefully worded to prevent manipulation of the properties during

the period of their control by the lessee. For example, if the lessee should build a competing property, it could render such poor service with the leased property that at the termination of the lease it would have no customers; all business would by that time have gone over to the new competitor Thus the lease will provide that the lessee shall not construct competing property, that all extensions naturally belonging to the landlord shall be constructed as the landlord's property, and that the service on the leased property shall be properly maintained. If it becomes expedient to discontinue the use of any of the leased property, the tenant may be required to build new property at its own expense to take the place of the discontinued property.

A clause is now usually added to this effect: "the continuity of the lessor's road, whenever returned to the lessor, and the connection between its several parts, shall be such that said lessor's road will be as well fitted for independent use and operation by the lessor as at the inception of this lease."

Return of leased premises.—The lease usually provides that an inventory shall be taken at the inception of the lease and that all properties shall be returned in kind or its equivalent. The returned property, of course, must include all improvements and additions.[25]

Cancellation of lease.—The lease usually provides that if the rent is not paid, the lessor may retake the property. Days

[25] A peculiar provision, the purpose of which does not seem clear, is contained in the lease made by the Tobacco Products Company of a part of its property to The American Tobacco Company for the term of 99 years from November 1, 1923, for an annual rental of $2,500,000 The lease covers certain businesses and brands, the property used in connection therewith being bought outright At the end of 99 years the lessee is to return "the business and brands covered by this lease" Then the instrument goes on to say· "AMERICAN Co. (lessee) shall have the right to commute its monthly payments under this contract at any time, by payment, in cash, to the PRODUCTS Co. or its nominee, of a number of dollars lawful money of the United States which, computing the return thereon at the rate of 7 per cent per annum, would purchase, and so represent the then present value of, an annuity, payable in equal monthly installments, of $2,500,000, for the then remaining balance of said ninety-nine (99) year term In the event of such commutation and upon the payment of the aforesaid sum, the licensed and leased goodwill, business and brands shall thereupon pass to the absolute ownership of the AMERICAN Co., who shall from thenceforth own and enjoy the same in perpetuity."

It would seem that at the end of 98 years the lessee might defeat the right of reversion apparently intended to remain in the lessor, by taking advantage of the above clause and by depositing the money for the annuity, which would be almost the same as the rent for the 99th year.

of grace—from thirty days to six months—are given and notice of intention to retake is required to be sent to the lessee in writing. Moreover, the lease may require that a notice addressed to the stockholders of the lessee must be published in several newspapers.

Usually a default will not take place unless the lessee is insolvent and a receiver has been appointed. Since the appointment of a receiver places all the property in the control of an equity court, before the landlord can retake the property it will have to apply to the court for permission.[26]

Control of lessor's subsidiaries.—When a lease is made, it generally carries with it control of all the landlord's properties. The lease usually provides that during the term of the lease the lessee may vote the stock of the lessor's subsidiaries and thus effectually control them. The lessee usually assumes the leases made by the lessor of other companies' properties.

Treatment of lessor's bonds maturing during the term of the lease.—If the lessor had issued bonds before the date of the lease, these bonds will have a claim on the property superior to that of the lessee's in case it becomes necessary to foreclose the lien securing the bonds. It is for that reason that the lessee always, in modern leases, agrees to pay interest on the outstanding bonds of the lessor directly, instead of paying a flat sum to the lessor and permitting it to pay its own bondholders. For much the same reason the lessee is interested in the payment or refunding of bonds that mature during the term of the lease, for if the obligation to pay them is not met, the bondholders may foreclose this mortgage and thus get control of the property away from the lessee. The lease will therefore provide that the lessor will issue other securities to be used by the lessee in refunding the lessor's bonds at maturity.

Effect of lease on capitalization of lessee.—The problem of figuring the net capitalization of a company and its leased properties may be simply stated and solved by using a few imaginary figures. Railroad company *A* controls company *B* by lease. *A*'s capitalization consists of $5,000,000 stock and $5,000,000 bonds. *B*'s capitalization consists of $1,000,000 5 per cent bonds on which *A* agrees to pay the interest, and $2,000,000 of stock on which *A* agrees to pay 10 per cent dividends. Is the total capitalization of the two roads $13,-

[26] Pa. Steel Co v. N Y. City Ry. Co., (1915) 225 Fed. Rep. 734.

000,000, that is, the combined stock and bonds of the two roads—\$5,000,000 + \$5,000,000 + \$1,000,000 + \$2,000,-000? The better method is not to consider the stock of *B* as a part of the capitalization but to calculate the actual money required to be paid as rent by company *A* and to capitalize it at a reasonable rate, say 5 or 6 per cent. Thus, if we use 5 per cent, the capitalized rent would be the interest on the bonds and the dividends (\$250,000) capitalized at 5 per cent, or \$5,000,000, and the combined capitalization would be not \$13,000,000 but \$15,000,000.

The justification for this procedure may be explained as follows. The \$200,000 (10 per cent of \$2,000,000) required to be paid by company *A* on company *B*'s stock is not, from the standpoint of company *A*, a dividend or contingent charge; it is a debt to be met annually. Indeed, it may be regarded as a true fixed charge. There is little difference between the purchase of the leased property with an issue of 5 per cent bonds running perpetually, and the lease of the property at 5 per cent of its value for, say, 9,999 years. Or, instead of having been consummated with a lease the transaction might have taken the form of a purchase of company *B*'s stock. Its stockholders would likely have asked \$200 a share. The capital sum required to buy the stock (\$4,000,000) might have been obtained by issuing \$4,000,000 of 5 per cent collateral trust bonds secured by the stock.[27]

In comparing the capitalization of one railroad with that of another, it is customary to reduce the capitalization to a "per mile" basis. When this is done the capitalization of the system as a whole (calculated where leases are involved as described above) should be divided by the mileage of the entire system. Thus, if in the above example company *A* owned eighty miles of road and the mileage of the leased roads of company *B* was 200, it would be unfair to say that company *A* was capitalized at \$10,000,000 divided by eighty, or \$125,-000 a mile. The "per mile" capitalization for the entire system would be \$15,000,000 divided by 280, or \$53,572 [28]

Leases coupled with stock ownership.—It is quite usual to find that leases are coupled with stock ownership. Sometimes the lease antedates the acquisition of the stock of the

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[27] See A. M. Sakolski, "Economics of American Railways," Chapter XII.

[28] For a practical example, see page 864 of Vol 1 of Investigation of Financial Transactions of the N. Y , N.H. & H., Senate Doc No 543, 62nd Congress.

leased properties and sometimes the acquisition of the stock antedates the lease. Thus a lease may be about to expire; since the stockholders of the leased property have been receiving a fixed return on their holdings, they will know very little about the true value of their company; the market value of their stock will not reflect any change in the value of their property but will be fixed by the dividends paid by the lessee. But these dividends may have been determined years before, when the earnings were small. When the expiration of the lease is imminent, the stockholders will make expert inquiry into the value of their properties and will probably demand higher dividends. It is therefore expedient for the lessee gradually to buy in the stock of its lessor[29] before such an expert valuation reveals the true value of the property and of the stock.

Where a company is controlled by stock ownership, a lease may subsequently be made to bind the intercorporate relations more closely and to prevent a disruption through concerted action on the part of outside stockholders of the lessor.

A curious system of intercorporate relations is sometimes built up by the use of the lease and stock ownership. Thus the Kings County Electric Light & Power Company (succeeded by the Brooklyn Edison Co., Inc.) owned all the stock of the Edison Electric Illuminating Company, but the former's property had been leased to the latter company for thirty years, the rental being the operating expense and fixed charges, that is, the interest on the bonds, and so forth, the surplus being turned over to the lessor parent company. One would say that the "eggs had been thoroughly scrambled."

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[29] The purchase of the stock under these circumstances must be accomplished with great care and secrecy. If the stockholders know that their stock is being sought by the lessee, they are likely to demand exorbitant prices Thus the stockholders of the Harlem River-Port Chester R. R Co, a lessor of the N. Y. Central, demanded in some instances $500 a share for their holdings, though under the terms of the lease they were bound for several hundred years to accept 8 per cent per year.

Chapter XXXI

HOLDING COMPANIES

Terminology.—All companies which hold the stocks of other corporations may be called holding companies. But the purposes for which stocks are held are so various that it may be wise to classify these purposes and to give a name to each class.

A *parent* company is an operating company that holds the stock of other operating companies. If the parent company actually controls the boards of directors of the other companies, no matter how small the percentages of the outstanding stock held, the latter companies are called subsidiaries.[1] Most of the large railroads come in this class, as do a great many of the larger industrial corporations.

A *holding* company is one that does no operating for itself but that does actively administer the affairs of subsidiaries.[1a] The United States Steel Corporation is an example of this class, which, however, is best represented by the holding companies in the public utility field, such as the Cities Service Company, the United Light & Power Company, and the United Gas Improvement Company.

A *financing* company is very similar to the holding company, though its main purpose is to aid in financing the acquisition of subsidiaries of the controlled properties, the extension of companies, the acquisition of equipment, the sale of equipment, and to aid in other matters that present strictly financial problems. The work of these companies will be described in detail later.

An *investment* company is a corporation (frequently a Massachusetts trust) that seeks no control over the companies whose securities it purchases. It undertakes no operating or administrative duties, but contents itself with making profitable investments of the moneys received from the sale of

[1] A corporation that merely holds some of the stock of another company, but is not in a position to dictate the latter's policy, can hardly be said to occupy the position of parent company

[1a] For definition of a holding company under the Public Utility Holding Company Act of 1935, see page 696

its securities. These companies will be discussed in detail later.

Right of corporation to acquire and hold stock.—In America, corporations are not permitted to hold the stock of other companies without statutory consent, or unless the holding of stock is incidental to their expressed powers, as for example, in the case of insurance and other companies charged with the investment of funds. In England, the common law rule "seems to be that a strictly private corporation 'may deal in the shares of other corporations, without express power so to do, provided the nature of its business be such as to render such transactions conducive to its prosperity.'"[2]

In America, in all but nine of the States, statutory provision has been made on the right of one corporation to hold stock of another These statutes either expressly permit the corporation to hold shares in other corporations as its purposes may require, or they give the corporation the power to do so without such limitation. The first statute was passed by New Jersey in 1896,[3] and it was in New Jersey that most of the large holding companies were formed at the opening of the twentieth century. In New York the rule is that one corporation may hold the stock of another corporation engaged in the same or similar line of business (provided, of course, the anti-trust statutes are not thereby broken); or a corporation may hold the stock of another corporation, without respect to the business of the two companies, provided the certificate of incorporation of the former corporation gives it that power. It is customary, therefore, in organizing companies, to include a provision to the effect that "this corporation shall have the power to hold the stocks, bonds, and other evidences of indebtedness of other corporations."

Voting the subsidiary's stock.—The board of directors of the holding company executes a proxy to one of its officers and instructs him how to vote the stock. If necessary, the directors of the subsidiaries are given "qualifying" shares, though in some States, including New York, the officers of

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[2] W C Noyes, "Intercorporate Relations," page 475 See generally *ibid* Chapters XXV, XXVI, and XXVII See, however, comment in article entitled "Power of a Corporation to Acquire Stock of another Corporation," 31 *Columbia Law Review*, 281 (February, 1931), to the effect that no support is found in decided cases for the statement contained in standard treatises on corporations that in England there is a general power to purchase stock.

[3] General Corporation Act of N J, Sec. 51.

the holding company are "eligible to the office of director" of the subsidiary.

How much stock is necessary to control.—In ordinary cases a majority ownership of a subsidiary's stock is necessary to insure control. But very frequently, a smaller interest will suffice. As we shall see, ordinarily a smaller amount of stock is necessary to retain control than to obtain control.[4] Hence a company may buy considerably less than half of the stock of another company from the directors, securing at the same time the latter's resignations, and may thus come into control of the subsidiary; whereas if an attempt were made to gather together a majority of the stock from isolated holdings, the task would be almost insuperable. Thus in 1901, when Harriman, backed by a group of New York bankers, tried to oust Hill from control of the Northern Pacific, he merely precipitated a scramble for the Northern Pacific stock that eventually got him nowhere.[5]

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[4] See also *ante*, pages 113 *et seq* for material paralleling this and the next few sections of the text above

[5] This fight is an interesting one and has frequently been described The outline of the events is as follows

The total capital stock outstanding of the Northern Pacific in 1901 was $80,000,000 of common stock, and $75,000,000 of redeemable preferred, both classes having voting power In an effort to obtain control of the company, E H Harriman, backed by Kuhn, Loeb & Co, bankers, bought until he owned $37,000,000 of the common and $42,000,000 of the preferred, or a total of $79,000,000, which gave him more than a majority interest J J Hill, who was originally in control of the company, and who was backed by J P Morgan & Co, purchased stock additional to his relatively small original holdings of the Northern Pacific until he owned $42,000,000 of the common and $29,000,000 of the preferred, giving him a total of $71,000,000 As a result of this contest the price of the stock shot up to $1,000 a share in 1901

Hill let it be rumored that the board of directors would exercise the option of the corporation to redeem the preferred If the corporation did exercise the option and redeem the preferred, the road would remain under the control of Hill because he had a clear majority of the common Though the right to redemption did not arise under the terms of the stock till the succeeding year, and though a meeting of stockholders was scheduled to be held in the meantime, Hill hinted that the meeting would be postponed till the preferred stock could be redeemed Had such moves been made, Harriman's control of all the stock would have been changed into a minority of the outstanding common stock.

Evidently both Hill and Harriman lost nerve and decided to combine forces They got together and formed the Northern Securities Company, a holding company which was to hold the stock of the Northern Pacific and Great Northern, a majority of which was owned by Hill and Harriman. Harriman owned about $80,000,000 of the Northern Pacific and about $50,000,000 of the Great Northern; Hill owned about $70,000,000 of the Northern Pacific and $150,000,000 of the Great Northern The shares of these two companies

An illustration of partial ownership and complete control.—An example of transfer of the control of a company with transfer of somewhat less than one-third the outstanding stock, is furnished by the acquisition of control of the Western Union Telegraph Company by the American Telephone & Telegraph Company. On November 16, 1909, it was announced that the American Telephone & Telegraph Company had obtained control of a large minority interest in the stock of the Western Union Telegraph Company. Neither the amount of shares acquired nor the price paid was made public, but it was rumored that from $20,000,000 to $25,000,000 of a total of $99,787,000 stock outstanding was purchased from the Gould holdings, with probably voting rights on an additional amount. However, it was stated by President Vail, of the American Telephone & Telegraph Company, at a hearing, that the purchase amounted to 300,000 shares out of the total of 1,000,000 shares.

The immediate result of this acquisition by the American Telephone & Telegraph Company was a change in the management of the Western Union. Ten new directors were elected, and though two of the Goulds still remained

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were to be exchanged for the shares of the Northern Securities Company. Harriman therefore received $^{13}/_{35}$ of the shares of the Northern Securities Company, and Hill $^{22}/_{35}$.

Hill and Harriman had some working arrangement and matters went along quite smoothly until the government brought a suit for the dissolution of the Northern Securities Company as a violation of the Sherman Anti-Trust Law, based on the contention that the combination eliminated competition between two roads that theretofore had been competing. In those days, it should be noted, the theory still was that rates and service were dependent largely on competition. The government was successful in its suit, the court ordering the Northern Securities Company to dissolve.

When a corporation is dissolved under the general principles and rules of law, each shareholder is entitled to a pro rata share of the assets of the dissolved corporation; and so Hill claimed that he should receive $^{22}/_{35}$ of the stock of the Northern Pacific and $^{22}/_{35}$ of the stock of the Great Northern. If this were done, however, Hill would be in control of both roads. Harriman claimed that the agreement forming the Northern Securities Company was void from the very beginning and, therefore, the parties should be placed in *status quo* and that each should receive the number of shares that each had put into the Northern Securities Company. Hill's contention was that the agreement of the Northern Securities Company was not void, but merely that the action of the Northern Securities Company in holding stock of competing lines was illegal; therefore, he contended, the contract was not void from the beginning and the shareholders should receive a pro rata share of the assets of the dissolved corporation. Hill was sustained and Harriman lost control of the Northern Pacific. Harriman v. Northern Securities, (1905) 197 U. S. 244.

directors, it was understood that they had tendered their resignations.

On March 31, 1913, the American Telephone & Telegraph Company owned $29,657,200 of the outstanding stock. On February 16, 1914, it was announced that in accordance with an agreement between the Department of Justice and the American Telephone & Telegraph Company, the latter had sold its entire holdings of the Western Union Telegraph Company stock to a syndicate, under an arrangement whereby the privilege was reserved to other stockholders of the Western Union Telegraph Company of subscribing for the same, pro rata at $63 per share on or before March 24, 1914, to an amount equal to 40 per cent of their holdings as of record on February 28, 1914. About one-half of the stock was subscribed for by stockholders.

For more recent examples of partial ownership and complete control, the student must look into the history of the promotion in 1929 of the United Corporation in the public utility field, and of the Alleghany Corporation in the railroad field [5a]

Use of proxies to retain control.—Undoubtedly the most important reason for the retention of control by a minority is the general practice among American companies of using the proxy and the proxy committee. The directors in power elect a proxy committee whose function it is to receive proxies and to vote them at the next annual meeting. Proxies made out in the name of this committee are mailed with the notice of the annual meeting, and stamped and addressed envelopes for their return upon execution are also included.[5b]

Most of the stock voted at meetings of large companies is represented by proxy, besides the large holdings of corporations, banks, and insurance companies that must perforce be represented by proxy.[6]

[5a] The complicated transactions which brought about the United Corporation and made it a potent factor in the regrouping of utility properties are described in "High Finance in the 'Twenties The United Corporation," 37 *Columbia Law Review* 785, 936 See also 37 *Columbia Law Review* 1137 for a reëxamination of the promotion of the United Corporation with the purpose of illustrating the impact which the Securities Act of 1933 and the Securities Exchange Act of 1934 made upon the type of financing represented by the organization and development of the United Corporation For a summary of the organization and history of the Alleghany Corporation, see Report 1455, 73rd Congress, 2d Session, "Stock Exchange Practices," page 364 *et seq.*

[5b] See page 112 for restrictions on solicitation of proxies

[6] See page 114 for proportion of stockholders represented by proxy at annual meeting of the United States Steel Corporation.

Inactivity of outside stock.—Very frequently, a large part of a company's stock will be inactive. Mr. Mellen's experience as president of the New Haven is probably the same as that of every other president of a large corporation "Stockholders, in times of prosperity, and while dividends are being paid, are generally contented, like sheep, to go out and browse . Lots of them did not pay any attention to the proxies, and threw them in the waste basket, I suppose."[7] A large part of the stock of a company may be held by speculators who pay no attention to the voting rights [8]

Other devices for retaining control.—Stock may be divided into voting and non-voting stock and outside capital may thus be brought into a subsidiary without increasing its fixed charges and without jeopardizing control [9] Moreover, the control may be kept by a very small proportion of the stock by providing in the by-laws, if the statute does not preclude such a provision, that a larger percentage than a majority shall be required to elect directors. Thus, if the by-laws provided that seven-eighths of all the outstanding stock was needed to elect a board of directors, the old board, by controlling slightly more than one-eighth of the stock, could prevent the election of a new board and hence could "hold over" indefinitely.[10]

Affiliated companies under the Federal Income Tax Law.—The only affiliated corporations which may file consolidated income tax returns, under the Internal Revenue Code, as amended by the Revenue Act of 1939, are railroad companies and certain Pan American Trade Corporations [11] All other corporations must file separate returns regardless of affiliation.

Prior to the Revenue Act of 1934, consolidated returns were permissible and affiliated corporations were able to reduce

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[7] Financial Transactions of the N Y, N H. & H, Senate Document No 543, 62nd Congress, 2nd Session, pp 916, 917.

[8] See page 113 for Stock Exchange rules for brokers' proxies

[9] See page 108 for legislative curbs upon control through restrictions of voting rights

[10] The author regrets that he has been unable to find among his notes the name of a small Mid-Western railroad whose by-laws contained such a provision He recalls that in that case the provision was not left pregnable, for the charter provided that the by-laws could not be amended except by a seven-eighths vote of all the outstanding stock.

[11] Internal Revenue Code, Secs 141, 152.

their income taxes by combining the accounts of profit-making affiliates with those of companies operating at a loss.

Advantages of holding companies.—Many of the advantages claimed for this system of intercorporate relations—parent or holding company and subsidiary—apply to all forms of combination which eliminate competition and permit large-scale production.[11a] Here we shall consider only those advantages which are peculiar to corporate stockholding

Ease in effecting relationship.—The holding company relationship is perhaps the least troublesome to effect. The consent of stockholders of neither the holding company nor the subsidiary is needed to permit control through stock ownership, and all difficulties of having to deal with recalcitrant stockholders are avoided. As compared with combination by consolidation or purchase of assets, it has the advantage of avoiding the trouble of arriving at a financial plan that will be agreeable to all the parties concerned. Of course, the purchasing company has much the same difficulty in determining what it will pay in acquiring the securities of a company as the constituents of a merger or of a consolidation have in devising their financial plan, but it is not faced with the problem of dividing control, as are the promoters of a consolidation or merger

When the giant United States Steel Corporation was organized at the beginning of the twentieth century, vast economic interests were acquired by the technique of merger, consolidation, or outright purchase of assets. When the gigantic United Corporation was promoted during the second decade of the century, huge interests in other public utility holding companies were acquired without the necessity of raising cash; it became a great holding company, commanding control in large public utility systems, principally through the device of issuing unauthorized shares in exchange for the shares of individual owners of the companies involved. The plans always took into consideration the Federal income tax liabilities involved in a proposed exchange, and the exchanges were cast in such form that the Federal income taxes on large capital gains were avoided.[11b]

[11a] A holding company is not always able to put into effect economies that would be possible through a consolidation

[11b] This feature of the procedure is not generally criticized since the United States Supreme Court stated that "the legal right of a taxpayer to decrease

Adverse legislation.—The holding company has been used to overcome restrictive legislation under which it is difficult or impossible for a foreign corporation to carry on its business in a particular State.[11c] Thus, when in 1917 Texas passed a new pipe line law preventing the Texas Company from owning its pipe lines in that State, the corporation conveyed its pipe line properties in Texas and Louisiana to the Texas Pipe Line Company, a Texas corporation, for $14,000,000 stock of the latter company.

Readiness with which subsidiaries can be adjusted to local conditions.—Where a large part of a company's business is localized, it may prove advantageous to incorporate that part of the business separately. In this way, local representatives can be placed on the board of directors, they can be given offices with dignified titles, and the company can escape much of the criticism that might be directed against foreign ownership. Even the question of the name of the business may be important, for while an American corporation, for example, doing business in some foreign land, may translate its name into words of that land's language, difficulties might arise in connection with title to property. A corporation cannot use a pseudonym [12]

Experiments may be tried without injuring the parent company.—The subsidiary company grants the corporation the same limited liability that a natural person receives when he embarks on a new enterprise through the medium of a corporation. Whether the new enterprise shall be incorporated as a subsidiary or maintained as a department of the parent company is a question the solution of which must rest on the circumstances surrounding the case. For example, the credit

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what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted" Gregory v Helvering, (1935) 293 U S 465 For a description of the technique of share-for-share exchanges used by United Corporation during 1929 and 1930 to acquire huge equity interests in other public utility holding companies, see "High Finance in the 'Twenties," 37 *Columbia Law Review* 936

[11c] Several years ago the laws of some of the States provided that no foreign corporation could hold real estate within its borders This type of legislation has gradually been removed from the statute books Pennsylvania, for example, had such a provision until 1923

[12] For an example of the method of organizing a chain of subsidiary companies, see *ante*, page 240 The use of the subsidiary company in building extensions to railroads was frequently resorted to. See Cleveland and Powell, "Railroad Promotion and Capitalization."

and reputation of the parent company may be the very thing necessary, to give the enterprise a successful start. But if the undertaking is hazardous, it may be the course of wisdom to use a separate corporation for the experiment. This advantage also applies to the method that is selected in taking over companies that are already in existence. If they are taken over by lease, for example, the obligation of rent survives the failure of the leased property and persists as long as the lessee remains solvent. Subsidiaries generally can be disposed of. The investment made in the subsidiary may be lost, but at least the subsidiary can be turned loose without involving the parent company in additional loss.

Possibility of obtaining control of existing companies at small expense.—By going out quietly and picking up stock, the control of a company may sometimes be obtained when otherwise extravagant claims would be made by its stockholders if they were asked to give a lease or to enter a consolidation. Sometimes, too, a company whose potentialities are good may be bought up by a corporation in a position to develop those potentialities. The following is taken from the Boston News Bureau, August 9, 1916.

> Two years ago Charles M Schwab picked up the friendless and down-at-the-heel Fore River Corporation for a song The "song" was in the form of $600,000 Bethlehem Steel second mortgage bonds with a then market value of about 83 It is believed in banking circles that the earnings of the Fore River Corporation in these two years cannot have been less than $1,500,000, or thrice the purchase price.

To be sure, in attempting to acquire the stock of a corporation, the purchaser may find that the demand they have created has caused the price to go far above the value of the securities, making the cost of the acquisition exorbitant.

Permits capitalization of controlling stock by issue of collateral trust bonds.—But the acquisition of the controlling stock of a company need not cost the parent company any outlay of cash whatever. The stock may be deposited as security for an issue of collateral trust bonds and these may either be sold to the public to obtain the funds to be used for acquiring the stock, or they may be exchanged directly for the stock.[18] The Midvale Steel & Ordnance Company, for example, in 1916 created an issue of twenty-year 5 per cent

[18] See diagram, page 240.

convertible gold bonds of an authorized amount of $50,000,000 "to be secured by all the capital stock of the Cambria Steel Company acquired or to be acquired by the company." The indenture provided that the bonds were to be used "to reimburse the company for the actual cost of all additional Cambria stock acquired and pledged with the trustee, which cost shall not exceed an average of $81 per share."[14]

This system of using collateral bonds opens up the means of centering an endless amount of property in the hands of a few persons who need not invest a cent of their own money. As a matter of fact, by using a chain of parent companies and subsidiaries, the same effect can be obtained without the use of the collateral trust bonds but with the use of several companies' earnings. Thus if a group of persons with borrowed money can control company *A*, and with its earnings buy up company *B*, while *B* is made to buy company *C*, and *C* is made to buy the *A* stock and thus pay the original loan, the directors of one company will elect those of another, and so on right around the circuit. The form of perpetual ownership created by this sort of organizing is one which the law abhors.[15]

Freedom from stockholders' suits.—Intercorporate relations may be brought about without starting stockholders' suits, some of which, as we have seen, are inspired by dishonest motives. The fact that a system can be built up in this way is evidenced by the experience of the New Haven railroad which, in 1911, had 336 subsidiaries. The development of the holding company system of intercorporate relations in the public utility field has also been conspicuously free from litigation of this kind.

Subsidiaries increase efficiency of system.—The late Judge Gary explained that the United States Steel Corporation was organized as a holding company rather than as a

[14] From the bond circular It should be noticed in this case, however, that the parent did make a considerable investment of its own money that was to be tied up in the subsidiary company's stock The circular reads "There is an initial pledge of stock of the Cambria Steel Company, costing more than $25,000,000, which is to be acquired with the sale of Midvale Steel & Ordnance Company stock Stock so acquired and pledged cannot serve as a basis of any issue of bonds and will, therefore, at all times represent an investment by the Company in Cambria Steel Company stock of more than $25,000,000 in excess of the proceeds of any bonds outstanding "

[15] For a somewhat similar transaction in practice, see the deals between the New Haven, The Navigation Company, and the New England Steamship Company, 27 Interstate Commerce Commission Reports, 591

consolidation, because the managers and officers of the constituents, could thus retain their old titles as presidents, vice-presidents, and the like, of their respective companies A spirit of competition and emulation is thus stirred up that makes, as nothing else can, for efficiency and success.

The practical working out of this advantage is explained in the following statement from the head of the statistical department of one of the largest holding companies in the country:

> Many years ago an old man said that in a certain business there were only two accounts—money coming in and what had to be spent to get it The latter item in a well-run electric plant is today divided into several hundred items of primary entry. These, in turn, are co-related with the statistics and tell the manager such items as the cost of boiler-room labor per ton of coal fired, or the cost of lubricating oil per thousand kilowatt hours generating, or, in the ultimate, the relative profit or loss in taking on this or that piece of additional business
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> All of these items in the accounts of an independent company, month in and month out, may be running along practically uniformly But without any outside basis of comparison, how is the isolated manager to know that all of these items of expense are as low as they should be? It is here that the holding company not only furnishes the bases of comparison, but itself makes the comparison and takes whatever steps are necessary in each item to bring the efficiency of all plants up to that of the best.[16]

Subsidiaries to hide trade secrets.—Very frequently, subsidiaries are used to hide trade secrets. A firm may wish, for example, to make an inferior and cheaper line of products that might interfere with the reputation it has gained for its earlier and more expensive products This can be done by selling the cheaper line through a subsidiary. This practice has been followed, with more or less secrecy, in the automobile field

Subsidiaries to carry on work which parent is not permitted to do.—Sometimes a subsidiary must be formed to carry on cognate work that cannot be prosecuted by the parent company under its charter [17] Railroads have frequently formed corporations to hold the properties of other companies carry-

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[16] *N Y Evening Post, Special Public Utility Supplement,* March, 1914

[17] Formerly many banks organized affiliated or subsidiary companies to deal in securities For example, the avowed purpose for the formation of the National City Co was to permit the National City Bank of New York to make investments not within the scope of the bank's power The Banking Acts of 1933 and 1935 placed such restrictions upon banking operations as in effect to prohibit a bank from having security affiliates

ing on various businesses. Thus the Northwestern Improvement Company, a subsidiary of the Northern Pacific, was the latter's holding company for the stocks of navigation, irrigation, express, and mining companies.[18]

Subsidiary organized to aid in profit sharing, etc.—A subsidiary may be organized to aid in profit sharing, though on the whole for small companies the simpler device of "management shares," described in an earlier chapter (see page 156), is preferable. Thus, the General Motors Corporation worked out a plan of profit-sharing in 1923 which involved the formation of Managers Securities Co.[19]

Fighting subsidiaries.—Frequently, the use of the subsidiary company has been as nefarious as it has been secret. Almost everybody is now familiar with the fighting companies employed by the old oil trust some time ago. If a competitor turned up to contest the monopolist's control, instead of killing off the competitor with lowered prices for products of the monopolist—a practice that would affect adversely the public's opinion of the quality of the monopolist's goods—fighting companies were organized whose goods were sold low enough until the spirit of the daring or stupid competitor was broken and its pocketbook flattened.

Subsidiaries to aid investors in company's stock.—In connection with the discussion of sale of securities, there is described on page 376 the functions of a subsidiary organized to aid investors in acquiring securities of the major corporation. Subsidiaries have also been used to carry through employee stock ownership plans Thus the Electrical Products Corp., which was controlled by the holding company Claude Neon Electric Products Corp., formed a wholly owned subsidiary to acquire stock in the holding company, the stock to be offered to employees of the Electrical Products Corp. Subsidiaries have been formed also to administer employee

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[18] This company was organized in 1897 but its charter was canceled in 1907. Another example is the New England Investment & Securities Co in the New Haven system.

[19] The plan involving the Management Securities Co terminated by expiration of the company's contractual relations with General Motors Corporation at the close of 1929 In 1930 the stockholders approved a plan for the formation of the General Motors Management Corporation, which, according to the annual report of the General Motors Corporation for 1930, fulfills "the same functions in principle," as the former plan In 1938, General Motors Management Corporation and General Motors Securities Co. were consolidated into General Motors Shares, Inc

life insurance plans. An example is the Employees Welfare Association, Inc., of the Associated Gas and Electric Company and New England Gas and Electric Association holding-company systems.

Other purposes for which subsidiaries are formed.—Some of the purposes for which subsidiaries may be formed have been treated in the discussion of the advantages of holding company and subsidiaries as a form of intercorporate relations The following additional purposes may be cited (1) To handle a particular department of a business. Thus, many large corporations have formed subsidiary sales companies to handle the distribution of their products, also finance companies, advertising companies, insurance companies, producing companies, and the like. (2) To carry on business in foreign countries. (3) To do business as a local institution in another State. (4) To act as a holding company for concerns which are closely grouped geographically. (5) To permit the joint use of one property by several companies. For example, the Boston Terminal Company is jointly owned by the New York, New Haven and Hartford, the Boston & Providence, the New York Central, and the Old Colony. (6) To clear up a situation of overlapping patents. For example, if several companies have overlapping patents and each is unable to grant licenses under them because of danger of complaint and suit by the others, they may solve the problem by forming a jointly owned subsidiary company to own all the overlapping patents. (7) To protect a trade name The Elco Company, for instance, was formed by the Electric Boat Company to preserve the name of Elco for its own use. (8) To keep separate and distinct a branch of a business that is affected by the terms of a will (9) To liquidate certain assets of a parent company. A losing branch of a business can be turned over to a subsidiary company to be sold out if it cannot be revived. (10) To liquidate assets acquired in settlement of debt. Thus, Manufacturers Trust Company organized Utility Service Company in 1932 to hold the bank's equity interests in public utility securities which had been acquired through liquidation of indebtedness to the bank.[20]

[20] A holding company which is temporarily a holding company solely by reason of the acquisition of securities for purposes of liquidation or distribution in connection with a bona fide debt previously contracted is exempt from the Public Utility Holding Company Act of 1935

Disadvantages of holding companies—taxation.—But it must not be thought that the holding company is without disadvantages.[21] Indeed, many corporations have consolidated their subsidiaries to get rid of the multiplex taxes and requirements regarding reports.[22] Taxes, of course, are saved by the elimination of subsidiaries, for every one of the latter has to pay a State franchise tax. To save duplicate taxes, in 1918 a number of American holding companies in the mining field were given up, the stockholders being paid for their stock in the stock of their Canadian subsidiaries. Examples were the Nipissing Mines Co., Kerr Lake Mining Co., and La Rose Mines, Inc.

The author finds in his files literally dozens of instances of the dissolution of holding companies, the consolidation of subsidiaries, or some other device to simplify the intercorporate scheme. One method of simplifying the combination of holding company with a number of subsidiaries is to make one of the subsidiaries the principal corporation, to get the holders of the holding company's stock to exchange their holding company stock for stock of the principal operating company, and then to cause the other subsidiaries to transfer their assets to this operating company, thus bringing all the producing property directly under the control of a single corporation. A dissolution plan of this kind was effected by Phelps, Dodge & Co in 1917.

Dissipation of goodwill.—The holding company with subsidiaries may suffer from a scattering of effort, especially in the marketing field. The name of a company's products, when identified with the corporate name, makes an impression on the public through advertising, and often there is no reason for not spreading the effect of the effort and cost over the product of the subsidiaries as well. We have an illustration of this situation and the proposed remedy in an announcement

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[21] Professor W. Z Ripley brought before the public in "Main Street and Wall Street" (1927) the dangers of over-complication of the corporate structure

[22] When the privilege of filing consolidated returns was denied (see page 684), it was no longer possible to offset the losses of one subsidiary against the profits of another One of the former advantages of the holding company was thus destroyed The use of the holding company device is also discouraged by the method of taxing corporations upon dividends received from other corporations Under former Federal income tax laws, dividends received by holding companies from their subsidiaries were not taxable Beginning with the 1934 Act, a portion of such dividends became taxable to the holding company, and the tendency has been to increase taxes upon such income

of President William H. Childs to the stockholders of the American Coal Products Company, January 13, 1916:

It has become impressed upon the officials of the company that the large increased goodwill of the Barrett Manufacturing Co is not reflected in the value of the stock of the American Coal Products Co, due to the fact that such advertising is done in the name of the Barrett Manufacturing Co and the public in general does not realize the fact that all of the stock of the Barrett Manufacturing Co is owned by the American Coal Products Co

In order to simplify bookkeeping and save a considerable expense thereby and also to insure easier understanding by the public of the transactions of the company, it is proposed to change the name of the American Coal Products Co to the Barrett Company, with a similar amount of stock as in the American Coal Products Co and exchange all stock certificates, share for share, to that end We shall at the same time dissolve a number of subsidiary corporations, turning their assets directly into the Barrett Co

Manipulation.—Because the stock of subsidiaries may be acquired by the parent company through action of the latter's directors in private contract with the holders of the stock of the subsidiaries, there is always some danger that the parent company will be mulcted by secret deals of its directors.[23] The directors may decide to purchase the stock of a given subsidiary, whereupon they buy up the stock or "suggest" that friends buy it up at a price lower than that which the prospective parent company is willing to pay. It would seem that as to purchases of stock of prospective subsidiaries, directors are in much the same position as promoters. If a promoter owns property before he begins to promote, he may charge the company the true value of the property sold—the value, of course, to be fixed as of the date of beginning promotion—and this may be done even though the promoter originally bought the property at a much lower price. And so with a director, he may sell stock for its reasonable value; but if he purchases the stock for the purpose of resale to his company, he will be bound to sell it at the price paid for it. But the question always may arise: how much did the director pay for the stock?

Danger of manipulation that will be hurtful to the interests of the stockholders of the subsidiary corporation also lurks in the device of the subsidiary corporation. Thus, there is the possibility that the parent corporation will divert to other

[23] The history of railroad finance furnishes illustrations, a number of which are recorded by Ripley in his "Railroads, Finance and Organization" See also Interstate Commerce Commission Reports No 6833, pages 142 *et seq*

enterprises controlled by itself, funds raised through the sale of a subsidiary's stock or bonds.

The interests of security holders other than stockholders may also be injured by a wrongful use of the subsidiary device. Thus, a parent corporation may have outstanding an issue of debentures under which it is obligated ratably to secure the debenture holders in case any of its property is mortgaged. Parent corporations have been known to evade this obligation through a transfer of the property to be mortgaged to a subsidiary corporation. The property of the subsidiary, rather than that of the parent company, is then mortgaged, and the provision as to ratably securing the debenture holders is totally ignored Some measure of protection against such manipulation is afforded to creditors of a corporation by the rule that the legal fiction of a distinct corporate existence of the subsidiary will be disregarded when necessary to prevent fraud.[24] Carefully drawn indentures governing the issuance of the debentures may also avoid such manipulation.

Manipulation of subsidiaries' accounts.—Holding companies may manipulate the accounts of subsidiaries with great ease. If a parent company does not publish a combined income statement of itself and its subsidiaries, and does not publish the subsidiaries' several income statements and balance sheets, secret reserves may be built up in the subsidiaries which may be unexpectedly transferred to the parent company through the declaration of a dividend on the subsidiaries' stocks, thus opening the way for an unexpected "melon" to be cut by the parent company. This melon, likely, would not be "cut" till the directors had acquired from discouraged stockholders a large amount of their stock at inadequate prices.

On the other hand, suppression of the bad financial condition of subsidiaries has often led to disaster. The Claflin failure was due, in large measure, to the insolvency of practically every one of its nineteen subsidiaries. New Haven's surprising failure to continue dividends was due to the taking on of numerous subsidiaries that either were operating at a loss when taken over or that afterwards suffered large deficits in their operating accounts.

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[24] For a discussion of the legal principles involved in the manipulation of credit through subsidiary corporations, see "Subsidiary Corporations and Credit Manipulation," by A. A. Berle, *Harvard Law Review*, May, 1928.

In the public utility field there have been numerous examples of attempts, through the use of subsidiaries and contracts between parent and subsidiary, to defeat regulations of the public service commissions. The courts have made it clear, however, that a public utility cannot defeat the right of a State to fix reasonable rates through the device of reducing apparent earnings by giving unduly favorable contracts to related companies

Holding company abuses—corrective legislation.—So flagrant were the abuses of the holding company device during the twenties in the banking, public utilities, and railroad fields that even those who firmly adhered to the holding company system and who took part in its development conceded that Government regulation of holding companies was essential.[25] The evils of the holding company system as it developed during the twenties are summed up as follows in a Government report

> . Holding companies have not been organized or dominated by individuals who possessed the necessary qualifications, training for or interest in industry, which formed the backbone of the holding company, but rather have become the vehicles for the financial promoters, who were particularly adept at borrowing money, pyramiding corporation upon corporation, and selling securities to the public
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> The holding company is no longer the parent fostering the unit industries, rather, the infant unit operating companies are nurturing the holding company The pragmatic result has been that holding companies have not created any economic wealth, but have merely facilitated the concentration of control of wealth.[26]

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[25] Such individuals as George Whitney, Owen D Young, Insull, Oris P Van Sweringen, and such companies as J P Morgan & Co admitted the need for regulation For reference to their testimony, see Report No 1455 of the Committee on Banking and Currency, 73rd Congress, 2d Session, "Stock Exchange Practices," page 382

[26] The facts disclosing the evils of holding companies in the electric and gas utilities fields are found in reports of the Federal Trade Commission made pursuant to S Res 83 (70th Congress, 1st Session); the reports of the Committee on Interstate and Foreign Commerce, made pursuant to H Res 59 (72d Congress, 1st Session) and H J Res 572 (72d Congress, 2d Session); and other reports See report cited in preceding footnote The evils are referred to in Section 1 of the Public Utility Holding Company Act of 1935 They may be summarized as follows: (1) lack of information necessary to appraise the financial position of earning power of securities, (2) issuance of securities without approval or consent of State public service commissions. (3) issuance of securities upon the basis of fictitious and unsound values, (4) overcapitalization, which tended to prevent voluntary rate reductions, (5) excessive charges against subsidiaries for services, construction work, equipment, and materials due to absence of arm's length bargaining; (6)

We cannot here go into a detailed account of legislation which was enacted to check the evils of holding companies. The Securities Act of 1933[27] with its requirements for disclosure of facts, the Securities Exchange Act of 1934 with its control of the use of securities exchanges in the distribution of securities, the Banking Acts of 1933 and 1935 with their restrictions upon banking operations,[28] the Federal income tax laws with their discouragement of holding companies,[29] and especially the Public Utility Holding Company Act of 1935, aim at elimination of the abuses of the holding company device.

The Public Utility Holding Company Act of 1935.—Companies owning or controlling 10 per cent or more of voting securities of an electric or gas utility company, or exercising a controlling influence over the management or policies of such a company, are termed holding companies under the Public Utility Holding Company Act of 1935. They and their subsidiaries are subject to the Act unless they are declared not to be holding companies or subsidiaries by the Securities and Exchange Commission or are exempt from the provisions of the law We cannot here explain the exemptions except to indicate that companies which are predominantly intrastate in character are exempt [30]

Methods of controlling public utility holding companies.—Control of holding companies which are subject to the Act is exercised in various ways. They may be summarized briefly as follows:

1. *Registration of holding companies.*—All holding companies must file a registration statement with the Securities and Exchange Commission. Companies failing to register are denied the right to distribute their products in interstate commerce and to do certain other acts.

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obstruction and complication of State regulation; (7) growth and extension of holding companies without relation to economy of management and operation or the integration and coordination of related operating properties, (8) lack of economy in management, operation, and financing of public utility companies, (9) lack of efficiency and adequacy of service rendered, (10) lack of effective public regulation

[27] See footnote 5a, page 683

[28] See footnote 17, page 689.

[29] See footnote 22, page 692.

[30] For complete information on the Public Utility Holding Company Act of 1935, see Prentice-Hall Securities Regulation Service.

2. *Regulation of security transactions.*—A declaration must be filed with the Securities and Exchange Commission with respect to any proposed issue of securities. See pages 360 and 439.

3. *Restrictions against acquisitions.*—An order of approval by the Commission must be obtained before any acquisition of securities, utility assets, and interests in other businesses may be acquired. This restriction was designed to give the Commission supervision over the development of utility holding company systems.

4. *Simplification of holding company systems*—Each registered holding company must take steps to limit the operations of its holding company system to a single integrated public utility as defined in the Act,[31] and to such other businesses as are reasonably incidental or economically necessary or proper to the operation of such integrated public utility systems.[32] Under certain conditions, however, a registered holding company may be permitted to control one or more additional integrated public utility systems. Two alternative methods are provided for securing compliance with the simplification requirements of the Act, namely (1) by an order from the Securities and Exchange Commission which may be enforced through the courts, or (2) by a voluntary plan. The Commission has favored compliance through voluntary and cooperative proceedings rather than by involuntary proceedings

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[31] An integrated system for an electric light and power company would be one "consisting of one or more units of generating plants, and/or distributing facilities, whose utility assets, whether owned by one or more electric utility companies, are physically interconnected or capable of physical interconnection and which under normal conditions may be economically operated as a single interconnected and coordinated system confined in its operations to a single area or region, in one or more States, not so large as to impair (considering the state of the art and the area or region affected) the advantages of localized management, efficient operation, and the effectiveness of regulation" A definition is also provided for an integrated gas utility

[32] When the Public Utility Act was passed, Section 11, dealing with the simplification of holding company systems, became known as the "death sentence" provision This phrase was less frequently heard after the Act was declared constitutional and holding companies became reconciled to its terms The following objectives are sought by Section 11 (1) the creation of geographically integrated systems whose business is confined to operating gas or electric properties; (2) elimination of unnecessary holding companies, (3) simplification of corporate structure of holding company systems; (4) distribution of voting control among security holders fairly and equitably.

Under the Act the structure of a holding company system is limited to three tiers, consisting of operating companies, first degree holding companies, and second degree or top holding companies [33]

5. *Regulation of intercompany transactions.*—Certain intercompany transactions are prohibited, and others may not be undertaken in contravention of the rules, regulations, and orders of the Commission. Thus, a registered holding company may not borrow or receive an extension of credit from a public utility company in its system or a subsidiary of the holding company This is a flat prohibition of the so-called "up-stream" loan. "Down-stream" loans—that is, extension of credit by a registered holding company to any company in the same holding company system—is not prohibited but is subject to regulation. Other transactions that are subject to regulation are the declaration of dividends, acquisition of the corporation's own securities, disposition of assets, and solicitation of proxies.

6. *Regulation of service, sales, and construction contracts.*—Restrictions are contained in the Act concerning service, sales, and construction contracts. These provisions are designed to protect public utility companies against tribute formerly exacted in the performance of service, sales, and construction contracts by their holding companies. Approved mutual

[33] The first voluntary plan of reorganization approved by the Securities and Exchange Commission was that of American Water Works and Electric Co Before reorganization the top holding company in this system was a fifth degree holding company with respect to one subsidiary, and a fourth degree holding company with respect to another subsidiary After simplification there was a top holding company, three subsidiary companies which are both operating and first degree holding companies, and a bottom tier of operating companies See Meck and Cary, "Regulation of Corporation Finance and Management under the Public Utility Holding Company Act of 1935," 52 *Harvard Law Review* 216

An analysis of the maze created during the twenties by the purchase of one holding company by another, and the formation by existing holding companies of subsidiary holding companies to handle a group of operating companies located far from the headquarters of the larger holding company, revealed three main types of "super" corporations (1) the "super" holding company, which owned all or a substantial majority of the voting stock of various holding and operating subsidiaries; (2) the management company, which owned substantial interests in its affiliated companies but did not control a majority of the stock, and (3) the investment company, which was generally formed to hold public utility securities, and which resembles the investment trusts described on page 703 For a review of holding company structures before enactment of the Public Utility Holding Company Act of 1935 see "Interrelation of the Utilities," with chart, by Harry T Rohs, *Barron's*, Feb 2, 1931.

service companies and certain subsidiaries may, under rules and regulations prescribed by the Commission, perform service or construction work for, or sell goods to, associated companies See also page 700.

7. *Restrictions against officers and directors.*—An officer or director of a registered holding company must file with the Securities and Exchange Commission at the time of registration of the company, or within ten days after becoming an officer or director, a statement of the securities of the company or a subsidiary thereof beneficially owned by him. Changes in ownership during the month must also be reported within ten days after the close of the month.[34] The provision as to liability for forfeiture of profits realized by an officer or director of a registered holding company or subsidiary on a purchase and sale or sale and purchase of a security of the company or subsidiary within a period of less than six months was previously discussed.[35] Another restriction is that a registered holding company or subsidiary may not have as an officer or director any executive, officer, director, partner, appointee, or representative of a bank, trust company, investment banker, or banking firm, or any such officer or representative of a corporation a majority of whose stock is owned by such banking company.

8 *Reports and accounts.*—Registered holding companies and mutual service companies are required to file certain reports with the Securities and Exchange Commission. Furthermore, accounts and records must be kept and preserved in accordance with the rules, regulations, and orders of the Commission by registered holding companies and their subsidiaries, affiliates of registered holding companies or subsidiaries of any public utility company, mutual service companies and their affiliates, and persons whose business is performance of service, sales, or construction contracts for public utility or holding companies.

9. *Liabilities for violations* —Criminal liabilities are imposed for wilful violation of the Act or any rule, regulation, or order of the Commission, and civil and criminal liabilities are imposed for false and misleading statements in applications, reports, documents, accounts, or records.

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[34] See footnote 4 on page 103

[35] See footnote 24 on page 49

Valuation of subsidiaries.—What was said in the discussion of manipulation indicates that a corporation's financial condition may often depend upon the condition of its subsidiaries. A rule, which even the Interstate Commerce Commission permits, provides that the value of investments in subsidiaries may be stated in the parent company's balance sheet at cost or present market value.[36] Perhaps most railroads, industrials, and utilities do not bother to revalue their investments from year to year—this practice being confined generally to banks and insurance companies—and it becomes important, therefore, for one who is studying a corporate report, to give careful attention to the analysis of the investments of the parent company in the stock of the subsidiaries The valuation may be made (1) by looking up the market value of the subsidiaries' stock, where there is any outstanding and it is dealt in on the exchanges, and (2) by capitalizing the average earnings of the subsidiary available for dividends.

Services rendered to subsidiaries.—A holding company which is exempt from the provisions of the Public Utility Holding Company Act of 1935 usually renders to its subsidiaries service relating to problems common to all of them Thus, it generally furnishes services in auditing, accounting, insurance, actuarial and taxation matters, and counsel in executive, rate, operating, sales, advertising, publicity, and financial matters. The fees received by the holding company for such services are often determined as a percentage of the gross profits of the operating units, or as a lump sum. The fees are an operating expense of the operating company and as such are subject to supervision by State regulating commissions.

As indicated on page 698, holding companies which are subject to the Public Utility Holding Company Act of 1935 must observe the restrictions contained in the Act concerning service and construction contracts with associated companies and sales to such companies.

With a few exceptions, only mutual service companies or subsidiary service companies may render service to associated companies, and these service companies must be so organized

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[36] Classification of Income, Profit and Loss and General Balance Sheet Accounts, issued 1914; special instructions No 5. Under the uniform system of accounts prescribed by the Securities and Exchange Commission for public utility holding companies, investments in other companies are included at cost

as to meet the requirements of the Act with respect to reasonable assurance of efficiency and economical performance of service at cost, fairly and equitably allocated among the serviced companies Federal Advisers, Inc., for example, is the subsidiary service company for the Federal Light and Traction System, a registered holding company. This service company has twelve departments, which perform the following services (1) executive and operating; (2) engineering and construction supervision; (3) purchasing, (4) secretarial, (5) statistical; (6) accounting, (7) insurance, (8) rate; (9) budget, (10) financial, (11) tax; and (12) commercial. Engineers Public Service Company, Inc. is a mutual service company for the subsidiaries of Engineers Public Service Company, a registered holding company.

Financing services rendered to subsidiaries.—Since the enactment of the Public Utility Holding Company Act of 1935, the financing services rendered to subsidiaries consist principally of advice. Actual financing is done largely through the issuance of mortgage bonds and preferred stock of the operating companies. To some extent, temporary loans are made to subsidiaries out of the earnings of the parent company, the latter being reimbursed when the time is propitious for the subsidiary to finance permanently. The debt is an open account, bearing interest, which puts the holding company in the position of an unsecured creditor. These open accounts may run for several years. The Securities and Exchange Commission and some of the State commissions have discouraged the use of open accounts on the ground that they enable the holding company to take unfair advantage of the preferred stockholders. The attitude of the regulating bodies is that the parent company should not make advances on open account, but should take common stock of the subsidiary equivalent to the advances. Then, should the subsidiary get into financial difficulties, the parent company would have no advantage over the preferred stockholders.

Before the Securities and Exchange Commission was created, not only did holding companies render financial service to subsidiaries by advances on open account, but they also served as agencies through which permanent financing of the subsidiary was done. Thus, in some instances, the holding company purchased the securities of operating subsidiaries and arranged for their resale to the public through

bankers. A good deal of capital was raised for subsidiaries by sale of the holding company's own securities to the public. The nature of the securities sold by the holding company varied considerably over a period of years. At one time, collateral trust bonds of the holding company were the most common form of security used to finance subsidiaries if the holding company was not independently strong enough to sell debenture bonds and preferred stock. In the twenties, holding companies did a large part of their financing of subsidiaries by the issuance of debentures, largely unsecured, and by the sale of common stock.

Investment trusts.—An investment trust is an institution organized for the purpose of investing funds obtained through the sale of ownership interests therein, in stock, bonds, and other obligations of various corporations; the trust aims to afford investors greater safety of principal and a greater return on their investments than would be possible by individual investment It accomplishes its purpose through distribution of risks and a skilful selection of securities. Unlike the holding company, the investment trust does not seek to promote, finance, or control the corporations whose securities it purchases.

Investment trusts are a comparatively recent development in this country.[37] In 1920 only some forty such organizations were in existence. They increased rapidly in number during the following ten years, especially from 1923 to 1929. According to a report of the Securities and Exchange Commission,[38] 1,272 investment trusts and investment companies of all types existed between 1927 and 1936.[39] As a result of

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[37] Investment trusts originated in England and Scotland during the '70's Some writers point to the Massachusetts Hospital Life Insurance Company, incorporated in 1818 in Boston, as the earliest example of an investment trust While incorporated as an insurance company, the principal business of this organization was the selling of expert investment service through the trust device

[38] A study of investment trusts and investment companies was made by the Securities and Exchange Commission pursuant to Section 30 of the Public Utility Holding Company Act of 1935 The Commission's study dealt particularly with the years 1927–1936. It represents the most thorough treatment of the subject that has ever been made and should be referred to by anyone interested in investment trusts

[39] The Securities and Exchange Commission's statistical analysis of the sponsors of management investment companies proper, "sponsor" being used to designate the apparent dominant management group, showed the following

numerous liquidations and reorganizations, only 559 investment trusts and companies were known to the Commission to be still active at the end of 1936. In the rapid development, the principles of investment that were the basis of the older investment trusts were more or less abandoned. In the older trusts, for example, diversification of investments was assured by limitations placed on the amount that could be invested in any one kind of security. Today, while many of the investment trusts follow the diversification principles, others limit their investments to securities of a specialized group, such as banks, public utilities, insurance companies, chain stores, and similar groups.

Legal formation of investment trusts.—So far as the legal formation of investment trusts in this country today is concerned, only a few are created as Massachusetts trusts or common law trusts. Most of them are organized under the corporation laws of such States as Delaware, Massachusetts, Maryland, and other favorable States. In investment trusts of the corporate form, both the organization and the relationship of the owners to the corporation are the same as in business corporations.

Types of investment trusts.—In the above paragraph, investment trusts were classified on the basis of their legal form of organization. A classification on the basis of structure will give a clearer picture of the types of trusts found today in American investment trust practice. Classified in

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to be the situation in 1935

"At the end of 1935, brokers, retailers of securities, investment bankers, stock exchange members, etc , were the sponsors of the largest number of closed-end management investment companies proper, accounting for 39 companies with assets of $140,000,000, or 9% of total assets of that type of investment company. Houses of issue—firms whose primary business was the origination of securities in connection with their primary distribution—were sponsors of 22 companies with assets of $400,000,000, or 27% of total assets, individual promoters—individuals without apparent affiliation with any other particular firm or business—were sponsors of 31 companies with $428,000,000, or 29% of total assets; banks and trust companies sponsored 12 companies with $78,000,000, or 5% of total assets; investment counsel sponsored 2 companies with $5,200,000; and other and mixed sponsorships accounted for 16 companies with $81,000,000 of total assets One of the striking changes in the sponsorship of the closed-end companies within the period 1929–1935 was the ultimate disappearance because of the enactment of the Banking Act of 1933 of bank security affiliates as sponsors of investment companies, although these affiliates had as at the end of 1929 sponsored 9 investment companies with total assets of $136,000,000 Another significant change was the rise in importance of individual capitalists and promoters as sponsors." See page 704 for definition of "closed-end" companies.

this way, two main types of trusts are found: (1) the type which operates like a corporation, though it may be organized as a corporation or as a Massachusetts or common law trust. Such an investment trust sells its stock, bonds, or debentures to the public, invests in securities all or a part of the capital derived from investors in the trust, and holds and manages the investments subject only to such restrictions as are contained in the charter, by-laws, resolutions of directors, or in the agreements covering the issues of bonds or debentures. (2) The type which operates under an agreement of trust. Such an investment trust involves three parties. (*a*) the organizer of the trust, which may be a corporation organized for the purpose of creating other trusts in a similar manner and selling participations therein to the public, (*b*) the trustee who holds the property, which may be securities and/or cash, and who authenticates and delivers the certificates of participation to the creator of the trust, (*c*) the investors in the investment trust, that is, those who purchase the participating certificates.

For purposes of statistical analysis, the Securities and Exchange Commission has classified investment trusts and investment companies on the basis of clear distinctions of form and method of operation into the following major groups:

1. Management investment companies. These companies have no restrictions or only limited restrictions upon the investments which they make. The group comprises companies which generally diversify their investments widely, as well as companies which tend to concentrate their investments in special situations. Included in this group are the so-called "open-end" companies, whose principal distinguishing feature is the right of the security holder to require the company to redeem his securities at approximately their asset value, and the so-called "closed-end" companies, which do not possess this redemption feature.

2 Fixed and semi-fixed investment trusts. These are also known as the "unit" type trust. They offer the investor a certificate evidencing a beneficial ownership of an undivided interest in a unit or fixed number of specified securities which may only be changed under certain conditions.

3. Installment investment plans. In installment investment plans, certificates are sold to the public under which the purchaser usually makes monthly payments extending over

a period of years. These payments, after deduction of fees and expenses, are invested in certain underlying securities usually shares of an investment trust or company. These underlying shares are deposited with a banking institution, which holds them for the purchaser's account.

4 Face amount installment certificate companies. Face amount installment certificates are essentially obligations of the issuing company to pay a fixed sum at a specified maturity date and usually require periodic payments by the purchaser over a period of ten to fifteen years

5. Common or commingled trust funds. These organizations are in the nature of personal trusts where the investors acquire a beneficial interest in a common fund invested chiefly in securities and administered by a trustee, usually a bank or trust company.

CHAPTER XXXII

ILLEGAL COMBINATIONS

Scope of chapter.—In the foregoing chapters we discussed various methods by which corporations may come into intercorporate relations. We shall now review briefly the subject of illegal combinations. There may be a statute permitting consolidation of one or more companies, but if compliance with that statute brings about a result not contemplated by that statute but expressly interdicted by another statute, then the consolidation will be illegal. The most common illegal result that taints the organization and existence of the combination is, we shall see, the formation of a monopoly. Most of the subject matter of this chapter is quite technically legal and some of it deals with problems in economics. We shall try to steer clear of such technical and purely theoretical problems, the solutions for which would likely be sought in books of a nature different from this. But since this book deals with methods of business organization and management, there must be included some explanation of the somewhat complex and rapidly developing rules limiting the rights of corporations to come into intercorporate relations.

Classification of illegalities.—The illegal results that may arise from the formation of intercorporate relations may well be classified by reference to the nature of the principles of law violated. In the first place, there may be a violation of some principle of the common law or statute law pertaining to the powers of corporations. In the second place, there may be a violation of the common law of monopolies and of contracts in restraint of trade. In the third place, there may be a violation of State anti-trust statutes; and in the fourth place, a violation of the Federal anti-trust laws. Most of this chapter will be confined to violations of the Federal statutes.

Principles of corporation law—the trust.—We have seen that the various methods of *forming* intercorporate relations included certain forms of association—the gentlemen's agreement to maintain price or restrict output, the pool, and

the trust—which did not bring about an absolute fusion of the corporate identities or call for a common employment of the properties of the constituents. The gentlemen's agreements and the pools[1] generally violated no common law rules of corporations, but the trusts were held to involve certain violations. The trust, it will be recalled, was an intercorporate relation brought about by setting up a voting trust, under which the stockholders of competing companies turned over to a group of trustees the title to their stock, and with it the right to elect the directors of the several companies—directors who would act in harmony. The effect of this arrangement is practically to put control of the several companies into the hands of the trustees. The courts have held this result to be a violation of the following principles of the common law of corporations.[2]

1. Corporations cannot form partnerships.
2. Corporations cannot delegate their authority.
3. Corporations cannot consolidate without the consent of, and except in the manner prescribed by, the State.

Attention should here be called to the fact that these rules just enumerated and about to be considered have nothing to do with monopolies. They are, in fact, violated by a trust though no attempt is made to monopolize and though no approach is made to a monopoly.

Trusts as partnerships.—Corporations may not form partnerships, since the partnership relation "interferes with the management of the affairs of a corporation by its own officers, impairs the authority of the stockholders, involves the corporation in outside enterprises, and is opposed to public policy."[3]

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[1] The reader should not get the idea from the text that gentlemen's agreements and pools, the intent of which was to monopolize or to restrain trade, were not illegal However, they did not necessarily violate what is here termed the common law of corporations, that is, the law prescribing the powers and methods of conducting corporations These forms of association did, in many cases, violate the common law rules of monopolies and contracts in restraint of trade, as we shall see presently.

[2] The law of corporations was very briefly examined in connection with consolidation, sale of assets, and other forms of intercorporate relations. The discussion in the text, from this point on, practically shows that "trusts" as therein described are illegal The word "trust" is used to describe the employment of the voting trust device by several corporations using the same group of voting trustees.

[3] W. C. Noyes, "Intercorporate Relations," Sec. 314, and see cases there cited.

A trust, as above described, has practically all the elements of partnership relations. The Supreme Court of Tennessee characterized the trust agreement in the cotton seed oil trust in the following language: "The contract is, both technically and in its essential character, a partnership in so far as it is possible for corporations to form such an association."

Corporations cannot delegate authority.—In considering these trusts the courts have looked upon the stockholders as being and constituting the corporation, and then have fallen back on the well-known rule that a corporation cannot delegate its authority. This rule against delegating authority is based upon the fundamental principle that authority and privileges granted by the State cannot be redelegated by the recipient.

Irregular consolidation.—If corporations were permitted to consolidate without obtaining the consent of the State, it would be within the bounds of possibility for corporations to combine and become more powerful than the State itself. The right to combine, therefore, is a right to be conferred by the State, and like all other rights granted by sovereign power, it must be exercised exactly in the form which the sovereign prescribes. The logic that denounces the trust form of intercorporate organization may be arranged in syllogistic form as follows:

All forms of consolidation except those prescribed by the State are illegal.

The trust is a form of consolidation not prescribed by the State and therefore the trust is illegal.

That the minor premise is true—that the trust is indeed a form of consolidation—is evident if one will but consider how truly the trustees become in effect a permanent board of trustees of a consolidated company, and how like administrative puppets the nominal directors of the several companies may become.

Corporate combinations as monopolies.—Attempts to monopolize trade date back into ancient history,[4] and

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[4] "Thales, who was a meteorologist, was given about as much consideration in his time as the philosopher of today But even a meteorologist is human The superciliousness of his smug and successful townsmen finally got under his cuticle. So he determined to shift the laughter and to prove that the making of money was a simple thing Then he did what the monopolist has been doing since man was created He decided to control one of the necessities of life. Olives were of prime importance in that country. Thales,

medieval legal and economic histories recount many attempts at monopoly in England and elsewhere in the fifteenth century.[5] It would not be profitable for us to trace this history at length. Suffice it to say that the word "monopoly" originally was a technical legal term applied to monopolies created by the sovereign, granting to persons privileges they did not theretofore have and subtracting from others privileges which they theretofore had had.[6] Since this technical monopoly does not any longer exist, we may dismiss it and pass to the economic monopolies.

We may start out, then, with the proposition that economic monopolies are illegal, and that any combination of corporations, however organized, will be voidable if the result is an economic monopoly.

What are economic monopolies?—But the question is, what are economic monopolies? The courts have been struggling for centuries with just that question. We know

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through his knowledge of meteorology, determined that the next olive crop would be extraordinary With his savings he secretly leased one by one the olive presses until he controlled all of them. Then he waited

"The harvest season approached. The branches were laden with olives Suddenly the entire community discovered that it wanted oil presses immediately. The wiseacres awoke to find the foolish Thales in control Of course, they said among themselves that he would rent them at the usual price. Imagine their irritation and chagrin when they found that Thales exacted the last penny that the traffic in olive presses would bear

"The device of Thales, according to his biographer, Aristotle, consisted in procuring for himself a monopoly, which, being interpreted, means 'to sell alone,' or the exclusive control over a commodity

"Having demonstrated how foolish and easy it was to turn such a commercial trick, Thales returned to his own job, that of helping the world in some of its real problems.

"Strange it is that in spite of the fact that the laws of Moses, the Talmud, and the statutes of many nations have outlawed monopoly, man still is stupid enough to strive for this bauble It has always been the courtezan in commercial life Like the mistletoe clinging to the oak, so it is in the life of nations, a parasite with all the allurements that the sophist can throw around it, yet slowly crushing that to which it clings." From speech delivered by Hon. Houston Thompson, Federal Trade Commissioner, at the Second Pan-American Financial Congress, Washington, D. C, January 22, 1920.

[5] See W J Ashley, "English Economic History"; H. Levy, "Monopoly and Competition"; W. H Price, "The English Patents of Monopoly"; W. C Noyes, "Intercorporate Relations," Chapters XXXIII–XXXVII, Standard Oil Case (Standard Oil Co of New Jersey v U S, (1911) 221 U S. 1).

[6] These monopolies are famous to readers of history, who will recall the patents of monopoly granted to the East India Company and the Hudson Bay Co We have no such technical monopolies today, except perhaps the public utility monopolies granted by Public Service Commissions On the history of this subject see W H. Price, "The English Patents of Monopoly."

that back in the fifteenth century certain forms of what were considered uneconomic practices that were prevalent enough to attract public attention were interdicted.[7]

From that era forward, decisions are found from time to time which frown upon attempts to control the market of useful commodities. These decisions gradually became more abundant, and during the third quarter of the nineteenth century they became prolific. Since 1890 the number of monopoly cases tried under the common law has declined; complaints, instead of being based on the common law, are now raised under the anti-trust statutes. While it would seem that the existence of the statutes makes a consideration of the common law of monopolies a work of supererogation, it so happens that an understanding of the statute depends on an understanding of the common law, and we must therefore answer the question: what did the common law consider an economic monopoly?

A lengthy exposition of this subject would be out of place here. We shall content ourselves with quoting answers to our question given by two eminent authorities, and suggest that further study, if desired, may be pursued in the sources from which these quotations are taken. The late Chief Justice Taft, who, it will be recalled, was a judge in the United States Circuit Court of Appeals, President of the United States, and then Kent Professor of Law in Yale University, said, in a book on this topic,[8] after reviewing the subject historically:

> Therefore, we find that the state of the common law when Congress passed the anti-trust statute was that contracts in restraint of trade, in so far as they restrained a party to the contract, were void, unless they were reasonable in the sense that they were merely ancillary to a main contract which was lawful in its purpose, and were reasonably adapted and limited to that purpose, and that all contracts of combinations in which the con-

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[7] Some misapprehension exists as to the true nature of "forestalling," "regrating," and "engrossing." W C Noyes has shown that these anciently interdicted practices are now perfectly legal See "Intercorporate Relations," Sec 358. The decisions and statutes bearing on these practices merely show that the sovereign has the right to prevent the control of the market for the necessaries of life

[8] "The Anti-Trust Act and the Supreme Court," (1914), pages 20–21. And the late Chief Justice Taft added, to anticipate a subject to be considered later, "Our *anti-trust statute*, however, now makes such restraints, which were thus only void and unenforceable at common law, positively and affirmatively illegal, actionable, and indictable."

tracting parties agreed to combine to restrain the trade of a third party or affect it injuriously were void at common law, without exception, and there were no reasonable contracts or combinations in restraint of trade of that kind.

Judge Noyes, United States Circuit Judge, whose authorship in his opinions, as well as in his book, reflects a great legal mind, in "Intercorporate Relations," a work of deep research and characteristic keenness, summarizes the rules of common law from the host of legal opinions as follows:

(1) Any combination of corporations or individuals the object of which is, or the necessary or natural consequence of the operations of which will be, the control of the market for a useful commodity, is against public policy and unlawful

(2) Any combination of quasi-public corporations the object of which is, or the necessary or natural consequence of the operation of which will be, the increase of charges beyond reasonable rates, or the curtailment of facilities afforded the public, is against public policy and unlawful.

In defining "control of the market" as employed in the above rules, Judge Noyes says:

The phrase "control of the market" . . . means the control of the disposition of a given product in a given market It involves, primarily. the suppression of competition and, as incidental thereto.

(1) The control of production.

(2) The regulation of prices

It is not essential, however, to the control of the market, within the rule, that it should be complete. Practical control is sufficient; and this does not imply an absolute elimination of competition On the other hand, a mere restriction of competition does not give control of the market and is not unlawful . . Just where the line is to be drawn between a lawful and unlawful restriction of competition—just what restriction is practical suppression—must depend largely upon the facts and circumstances of each case. As said in Hoffman v. Brooks, a case not officially reported, "Those engaged in any trade or business may, to such limited extent as may be fairly necessary to protect their interests, enter into agreements which will result in diminishing competition and increasing prices "[9] Just the extent to which this may be done the courts have been careful not to define, just as they have refused to set monuments along the line between fairness and fraud.[10]

To which we may add the well-known legal expression, "for fear some people would try to hew so close to the line that some of the chips will fly over."

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[9] It would have been better had the court omitted these three words, "and increasing prices ".

[10] W. C. Noyes, "Intercorporate Relations," Secs. 352 and 356

State legislation against trusts.—It would seem that the common law had settled the question that monopolizing combinations of corporations are illegal, and that statutes would therefore be superfluous. Several reasons account for the statutes, State and Federal. In the first place, the popular feeling against so-called trusts, that is, monopolies, became so heated that political parties were compelled to do something about them in their pre-election promises, and the statutes served to redeem these promises. In the second place, the statutes actually did "put teeth" into the common law by turning a statement of illegality into a declaration of intention to forbid; the statutes were also intended as the basis for criminal prosecution. As the late Mr. Taft put it, under the common law, "when one party to such a contract sought to enforce it against another, the court left both where it found them and gave no aid to either. Our anti-trust statute, however, now makes such restraints, which were thus only void and unenforceable at common law, positively and affirmatively illegal, actionable and indictable."[11]

The States first passed anti-trust acts, thirteen States having such laws before the Federal act went into effect, and at least fourteen States and territories having constitutional provisions against trusts and monopolies before that time. Altogether, forty States have had such laws, most of which, though amended from time to time "to put more teeth" in them, are still on the statute books.[12]

The State statutes vary somewhat in the severity of their treatment of trusts.[13] Some, like Texas and Missouri, are very severe. New Jersey had no trust laws till 1913, when, under the administration of Governor Woodrow Wilson, the famous "Seven Sisters" statutes were enacted. These have been repealed.

The sharpening of competitive practices during the depression and the rapid increase in the growth of price-cutting outlets—"super-markets" and "cut-rate stores"—led to a revival in the thirties of State legislation dealing with resale price maintenance and unfair discriminations.

The first State law permitting resale price maintenance was passed in California in 1931. Today resale price mainte-

[11] "The Anti-Trust Act and the Supreme Court," page 21

[12] Seager and Gulick, "Trust and Corporation Problems," (1929) pages 341 *et seq*

[13] See *ibid.*, Chapter XVII, for a generalization of the nature of State anti-trust legislation.

nance laws are found in nearly all of the States.[13a] Generally speaking, they legalize contracts which provide for the maintenance by the buyers of certain stipulated minimum prices in the case of trade-marked or branded goods Third parties with notice are bound by the terms of such contracts regardless of whether they are parties to them. Contracts between manufacturers, wholesalers, and retailers (so-called horizontal contracts) are uniformly excluded from the operation of such statutes. The Tydings-Miller amendment to the Sherman Act makes the resale price maintenance contracts effective in interstate commerce. See page 714

Another group of State laws which were placed upon the statute books during the thirties is that prohibiting price discrimination and sales below cost. These acts are frequently referred to as unfair practice acts and fair or unfair sales acts.

The Sherman Anti-Trust Act.—The Federal anti-trust act, entitled "An act to protect trade and commerce against unlawful restraints and monopolies," was approved July 2, 1890. The statute in its original form contains only 718 words It may be divided into three parts, of which the first describes the acts prohibited and gives the penalties (Secs 1, 2, and 3). Sections 1 and 3 say in effect. "Every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce"—over which Congress has power of control, that is, interstate commerce, so-called, including foreign commerce, commerce in and with the territories and the District of Columbia—"is hereby declared to be illegal. Every person who shall make any such contract, or engage in any such combination or conspiracy, shall be deemed guilty of a misdemeanor, and, on conviction thereof, shall be punished by fine not exceeding five thousand dollars, or by imprisonment not exceeding one year, or by both said punishments, in the discretion of the court." See page 714 for amendment of Section 1.

Section 2 reads: "Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade

[13a] See Prentice-Hall Trade and Industry Service for list of States having such laws, as well as the texts of the laws See also *Law and Contemporary Problems*, Vol IV, No 3, June, 1937, containing a symposium on "Price Discrimination and Price Cutting"

or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanor, and, on conviction thereof, shall be punished" by punishments provided in sections 1 and 3.

The second part of the act includes sections 4, 5, 6, and 7, which relate to procedure and remedies—matters of interest chiefly to lawyers. The government is given the right to restrain violations of the act, and permits persons injured to bring action under the act for three-fold damages

The third part of the act, section 8, states a rule of construction, merely providing that the word "person" or "persons" shall include corporations and associations.

Amendments to the Sherman Act.—The review of other anti-trust legislation beginning on page 719 shows that the Sherman Act has been amended, in effect, by the passage of other legislation.

In 1937, Section 1 of the Sherman Act was amended by the passage of the Tydings-Miller bill This amendment legalizes resale price maintenance contracts for branded or trademarked goods sold in interstate commerce and resold within the jurisdiction of any State where such contracts have been legalized with respect to intrastate sales.[13b] Contracts between manufacturers, producers, wholesalers, brokers, factors, and retailers are not included. The benefits of the amendment are restricted to goods produced and sold under other than monopolistic conditions.

Interpretation of Sherman Act.—No piece of economic legislation has had a more interesting history than the so-called Sherman Anti-Trust Act—a bill named after the same Senator, John Sherman, who sponsored the bill for the purchase of silver. Senator George Frisbie Hoar, in his "Autobiography of Seventy Years" (Vol. II, page 22), says of Senator Sherman and the anti-trust bill, "I doubt very much whether he ever read it. If he did, I do not think he ever understood it. It was totally reconstructed in the Judiciary Committee." If the bill was conceived in indecision and misunderstanding, it certainly was interpreted with uncertainty and doubt. The Supreme Court of the United States has rendered close decisions, the Northern Securities Company being held illegal by a vote of 5 to 4, and the United States Steel Corporation

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[13b] See page 712

being held legal by a vote of 4 to 3 (two judges in this latter case not voting, though probably agreeing with the minority).

We cannot give an account of every case that has been decided under the law. The best we can do is to indicate very briefly a few of the important cases and the progress they have marked in the interpretation of the law

The first case before the Supreme Court was the Sugar case, in which the court decided that the combination was one of manufacturers and that the government did not show that the combination was going to affect interstate commerce Any act that Congress could pass, therefore, would not affect such a combination, for Congress has power to regulate interstate commerce only.[14]

Then came the Debs case,[15] in which the court had pointed out to it by astute railroad lawyers the far-reaching meaning of the law, which could be interpreted to include in its prohibition a combination of railroad employees to prevent railroad companies in interstate commerce from operating their roads till certain demands had been met.

Two cases involving combinations of railroads[16] then came up before our final tribunal for decision. Though both associations were held illegal, the court in its prevailing opinion

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[14] U S v E. C Knight, (1895) 156 U S I Undoubtedly this case was lost by the government because it was improperly prepared Had the facts been brought out properly, the decision might have been otherwise See Taft, "The Anti-Trust Act and the Supreme Court," page 59 See also B Wyman, "The Control of the Market"

It is interesting to note that the dissenting opinion of Justice Harlan later became the law of the court (See Ex-Attorney General George W Wickersham's lecture on the Sherman Anti-Trust Law, given before the New York Bar Association, March 15, 1916, contained in "Some Legal Phases of Corporate Financing, Reorganization and Regulation," 1917 edition, page 242) And it is still more interesting to note that when the Supreme Court in the Standard Oil case adopted the principles of Justice Harlan's dissenting opinion in the Sugar case, Justice Harlan criticised the majority of his colleagues and said that their opinion amounted to "judicial legislation" Small wonder, then, that the average man in the street sometimes wonders what it is all about The reader who is interested in following the exact current of argument will find a very understandable exposition in William Howard Taft's little book, "The Anti-Trust Act and the Supreme Court" (This book is a reprint of a series of articles appearing in the *New York Sunday Times*, issues of May and June, 1914.)

[15] *In re* Debs (1894) 64 Fed. Rep 724, (1895) 158 U S 564

[16] U S. v. Trans Missouri Freight Assn, (1897) 166 U S 290; U S v Joint Traffic Assn, (1898) 171 U S 505 These cases involved a number of railroads which had entered the associations for the purpose of fixing rates Both associations were held illegal

used language that subsequently threw much doubt on the meaning of the law. The troublesome sentence was one by Justice Peckham in the Joint Traffic Association case. "By the simple use of the term 'contract in restraint of trade,'" said Justice Peckham, "all contracts of that nature, whether valid at common law or otherwise, would be included, and not alone that kind of contract which was invalid, or unenforceable as being unreasonable restraint of trade." It may be said immediately that this sentence does not now represent the law.

The next case[17] is interesting because it is the first case of a combination of industrials held illegal by the Supreme Court. A number of pipe manufacturing companies in the middle-west entered an arrangement whereby the person offering the largest bonus to the association would get the privilege of submitting the lowest bid on calls for iron-pipe. These calls usually came from municipalities that wished the pipe for water, gas, or sewers. The successful bid was insured to the manufacturer offering the largest bonus to be divided amongst the other manufacturers, since the latter knew the price and submitted higher bids. The case was an open-and-shut violation of the anti-trust statute and the Supreme Court unanimously so held

In 1904 came the Northern Securities case,[18] which involved the question of the legality of the holding company of that name formed in the State of New Jersey to take from Messrs. Hill and Harriman their controlling holdings of the stock of the Great Northern and Northern Pacific Railroads. This case decided that the form of a transaction is not to be considered; the effect is the matter for inquiry. It may be proper within the rules of corporation law for one corporation to hold the stock of other corporations, but if the effect of this holding is to restrain trade, then the holding, by virtue of the anti-trust statute, is invalid.

We come now to what is generally considered the final step[19] in the authoritative construction and application of the law. The Supreme Court in the Standard Oil case and the Tobacco case held that to each set of facts submitted to

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[17] Addystone Pipe Co. v. U S (1899) 175 U S 211

[18] Northern Securities Company v U S, (1904) 193 U S 197.

[19] Standard Oil Co v U S (1911) 221 U. S 1, and U. S. v. American Tobacco Co. (1911) 221 U S 106.

the court in a "trust-busting" case, the court must apply the "rule of reason"—it must examine the facts and see if contracts and combinations exist which "by reason of intent or the inherent nature of the contemplated acts prejudice the public interests by unduly restricting competition or unduly restricting the course of trade."[20]

Subsequent to the Standard Oil and Tobacco cases, a number of trusts came before the United States Supreme Court.[21]

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[20] Nash v U S (1913) 229 U S 373, 376

[21] Standard Sanitary Manufacturing Co v U S, (1912) 226 U S 20 (The Bath-tub case, in which the rights of monopoly obtained by a patent for an invention were held not to be a sufficient excuse for forming a general monopoly to control a whole trade) U S v Union Pacific Railroad, (1912) 226 U S 61, which disrupted the Southern Pacific-Union Pacific combination U S v Reading Company, (1912) 226 U S 324 This case and the bath-tub case turn largely on the subject of intent Where monopoly is complete, good intentions are of no avail, and moreover it is no defense that the constituents did not intend a monopoly, but where the monopoly is incomplete, the intent is an important element U S v Patten, (1912) 226 U S 525, holding a corner in cotton to be within the prohibition of the statute U S v Winslow, (1912) 227 U S 202, in which it was held that three non-competing concerns will not violate the statute if they combine—mere bigness is not a test of illegality Nash v U S, (1912) 229 U S 373, and U S v Pacific and Arctic Ry and Navigation Co, (1912) 228 U S 87, were two criminal cases that resulted in convictions Strauss v Publishing Co, (1913) 231 U S 222, which held illegal an association of publishers who agreed not to sell to retailers who did not maintain the stipulated retail price of copyrighted books

Later cases deal not only with the Sherman Act, but with the Clayton Act and the Federal Trade Commission laws In U S v Keystone Watch Case Co, (1915) 218 Fed 502, the court did not find sufficient evidence that the public interest required it, to warrant breaking up the existing corporate entity The court reiterated that a business is not unlawful merely because of its size, but is unlawful as an unreasonable restraint if the growth has been accomplished by fraudulent, unfair, or oppressive methods against competitors or by arbitrarily fixing or maintaining prices, by limiting production, or otherwise, or by arbitrarily reducing the wages of workmen or the prices of raw materials.

In U S v American Can Co, (1916) 230 Fed 859, the district court held that the dissolution of the company would serve no public interest, and the organization was left undisturbed The suit was allowed to stand open until future events and actions should warrant a definite decision

In U S v United Shoe Machinery Co, (1918) 247 U S 32, the court upheld a company that had obtained control of the manufacture of 96 3 per cent of the total volume of shoe machinery This was one of the first cases in which the court recognized the advantages of large scale production, integration, and mergers

In U S v American Linseed Oil Co, (1922) 262 U S 371, a combination of large competing manufacturers and distributors of linseed oil, cocoa, and meal, by means of a subscription to a so-called exchange, conducted by a so-called bureau, whereby each subscriber was required to reveal intimate details of its affairs, furnish a schedule of prices and adhere thereto, as well as comply with other requirements, was held to be unlawful under the Sherman Act

Eastman Kodak Co v. Southern Photo Materials Co, (1927) 273 U. S,

In 1914 the late Professor William Howard Taft summed up the teachings of these decisions as follows:

It is possible for the owners of a business of manufacturing and selling useful articles of merchandise so to conduct their business as not to violate the inhibitions of the anti-trust law and yet to secure to themselves the benefit of the economies of management and of production due to the concentration under one control of large capital and many plants.

If they use no other inducement than the constant low price of their product and its good quality to attract custom, and their business is a profitable one, they violate no law

But if they attempt, by a use of their preponderating capital and by a sale of their goods temporarily at unduly low prices, to drive out of business their competitors, or if they attempt, by price-controlling contracts with their patrons and threats of non-dealing except upon such contracts, or by other methods of a similar character, to use the largeness of their resources and the extent of their output compared with the country's total output as a means of compelling custom and frightening off competition, then they disclose a purpose to restrain trade and to establish a monopoly and violate the act.[22]

Recent cases.—The Supreme Court was not active in handing down trust decisions during the war. Too much danger lurked in the disturbance of any industry controlled by such corporations as the United States Steel Corporation to warrant an attempt at readjustments.

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359 was an action for damages for injuries caused by violation of the Sherman Anti-Trust Act, brought against the Eastman Kodak Co for refusal to sell to the Southern Photo Materials Co at dealers' discounts The Kodak Co was held liable

In Paramount Famous Lasky Co v U S, (1930) 51 Sup Ct 42, the court held that the agreement between motion picture distributors and producers who were competitors in interstate business and controlled 60 per cent of the entire volume of business, to refuse to contract for a display of their pictures by exhibitors except on a standard form which provided for compulsory arbitration, was a violation of the Sherman Act, its manifest purpose being to limit the freedom of trade

In Appalachian Coals v U. S., (1933) 288 U S 344, 53 S Ct 471, the court, upholding the validity of an exclusive selling agency for the marketing of coal, held that a cooperative enterprise, otherwise free from objection, which carries with it no monopolistic menace, is not to be condemned as an undue restraint merely because it may effect a change in market conditions, where the change would be in mitigation of recognized evils and would not impair, but rather foster, fair competitive opportunities

In Interstate Circuit, Inc et al v Hoblitzelle, (1939) — U. S. —, 59 S Ct 467, the court held that an agreement between owners of a chain of theatres and motion picture distributors resulting in the imposition of uniform restrictive requirements upon the price to be charged and the policies to be followed by the particular class of exhibitors is an unreasonable restraint upon interstate commerce within the prohibition of the Sherman Anti-Trust Law

[22] W. H Taft, "The Anti-Trust Act and the Supreme Court," pages 126–7.

When it did renew its consideration of cases pending, its decisions showed an extension of the "rule of reason" quoted in the previous section, and an interpretation of the anti-trust statutes which does not discourage organizations of magnitude so long as they do not use their powers oppressively.[23]

Under recent decisions it would seem that in order to prove that the anti-trust laws have been violated, it must be shown: (1) that by limiting production, the combination has power to manipulate prices so that they are held above the level which would prevail if supply and demand were taking their natural course, and (2) that a corporation dominant in a particular field has followed business policies that showed an intent to monopolize. The recent decisions also show that the court has abandoned its early interpretation of free competition under the Sherman law. It now indorses integration and the elimination of competitive waste through combination into large business units.

Other anti-trust legislation.—In the following paragraphs we shall briefly review legislation enacted subsequent to the Sherman Act, relating to business combinations and trade practices.

Acts supplementing the Sherman anti-trust laws.—In 1903 an act was passed for expediting proceedings under the Sherman Act, and in 1904 witnesses were made immune from prosecution. In 1913 the Panama Canal Act prohibited the ownership of a competing water line by a railroad unless the Interstate Commerce Commission believed the ownership aided commerce or was convenient to the public. In 1913 an Act was passed which provides that in taking the depositions of witnesses for use in equity suits by the United States under the Sherman Act, and in the hearings before examiners or special masters appointed to take testimony, the proceedings shall be open to the public.

The Clayton Act.—The Clayton Act was passed in 1914 to correct those abuses which had escaped under the Sherman

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[23] See "Mergers and the Law," National Industrial Conference Board, for a review of important cases decided under the anti-trust laws. See also *ibid.*, pages 84 *et seq.*, for a summary of the present status of the law concerning mergers. See also Seager and Gulick, "Trust and Corporation Problems," Chapter XXI, and Toulmin, "Trade Agreements and the Anti-Trust Laws." See U. S. v. U. S. Steel, (1920) 251 U. S. 417, 40 S. Ct. 293, and U. S. v. International Harvester Co., (1927) 274 U. S. 693, (1914) 214 Fed. 987, (1925) 10 F. (2d) 827, for examples of large consolidations which were upheld.

Act. The following acts are declared unlawful by the Clayton Act where the effect is to lessen competition substantially, or where they tend to create a monopoly. (1) discriminations in prices between different purchasers of commodities; (2) leases and sales on condition that the lessee or purchaser shall not use or deal in the commodities of a competitor of the lessor or seller; (3) acquisitions of stock of other corporations. Interlocking directorates in large banking corporations and interlocking directorates or communities of interest between railroads and large supply companies are prohibited. Labor organizations and agricultural associations are excepted from the provisions of the law.

Amendment of Clayton Act by Robinson-Patman Act.—The Robinson-Patman Anti-Price Discrimination Act, passed in 1936, amends the Clayton Act to prohibit the specific abuses concerning price discrimination which grew up under the Clayton Act The statute outlaws certain price discriminatory practices in the sale and resale of commodities in the United States, including false brokerage, pseudo-advertising, and other discriminating service allowances which were found unfairly to favor the large buyer as against the small and independent business man. It is unlawful under the Act for a buyer engaged in interstate commerce knowingly to induce or receive a discrimination in price which is prohibited by the Act. The Act permits allowances for differences in the cost of manufacture, sale, or delivery resulting from differing measures or quantities in which the commodities are sold or delivered to the purchasers, but allows the Federal Trade Commission to fix quantity limits beyond which no discount will be allowed.

Federal Trade Commission Act.—The Federal Trade Commission Act, passed in 1914, prohibits unfair methods of competition. The provisions of the Act have been invoked by thousands of business men who seek the aid of the Federal Trade Commission, which was created by the Act, in investigating illegal acts in competition and in getting an order compelling unscrupulous competitors to desist from using unfair methods of competition.[24]

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[24] For procedure under Federal Trade Commission Act, see R S Harvey and E W. Bradford, "The Manual of the Federal Trade Commission" See also page 804, *post*, "Dissolution under anti-trust law proceedings"

The Wheeler-Lea amendment of the Act, passed in 1938, strengthens the existing legislation against unfair practices by providing that orders of the Commission automatically become final unless appealed from within sixty days, and by imposing penalties for violations of the Federal Trade Commission orders. The amendment also adds special provisions for the prevention of the dissemination of false advertising concerning foods, drugs, devices (meaning devices for use in the diagnosis, prevention, or treatment of disease), and cosmetics Criminal penalties are imposed for the publication of a false advertisement where the use of a commodity advertised may be injurious to health or where it is published with intent to defraud or mislead

Act protecting trade and commerce against violence.—The Act of June 18, 1934, seeks to protect trade and commerce against interference by violence, threats, coercion, or intimidation Certain acts are declared to constitute a felony, punishable by imprisonment from one to ten years or by fine of $10,000, or both

Anti-trust legislation applicable to special industries.—The following is a brief review of anti-trust legislation that is applicable to special industries.

The Packers & Stockyard Act of 1921 gives the Secretary of Agriculture, instead of the Federal Trade Commission, jurisdiction over the packers in enforcing the Clayton Act and the Federal Trade Commission Act Stockyards are made subject to regulation by the Secretary of Agriculture in much the same way that railroads are subject to regulation by the Interstate Commerce Commission. This act does not in any way relieve this class of business from the provisions of the anti-trust laws.

The Perishable Agricultural Commodities Act was passed in 1930 to suppress unfair and fraudulent practices in the marketing of perishable agricultural commodities in interstate and foreign commerce.

The Communications Act of 1934, which provides for the regulation of interstate and foreign communications by wire or radio, provides that all anti-trust laws shall be applicable to the manufacture and sale of and trade in radio apparatus and devices entering into radio communication.

Certain provisions of the Interstate Commerce Act make it unlawful for common carriers subject to the Act to make-

agreements or combinations for the pooling of freights or division of earnings of competing railroads, except upon approval of the Interstate Commerce Commission. Limitations are also placed upon the right of railroads to own, control, operate, or have any interest in competing common carriers by water Interlocking directors and officers are also forbidden except on authorization of the Commission. For right of carriers to combine, see page 723.

The amendments to the Federal Reserve Act permit the formation of corporations to engage in international or foreign banking, but prohibit such corporations from engaging in commerce or trade in commodities except as provided by the Act, and restrain them from directly or indirectly controlling or fixing or attempting to control or fix the price of such commodities

In 1894 the Wilson Tariff Act contained a clause similar to the Sherman Act, but somewhat broader in its scope, and with special reference to the import trade. This act was amended in 1913. The Revenue Act of 1916 and the Tariff Act of 1930 also contain certain provisions dealing with unfair competition as regards import trade

The Federal Alcohol Administration Act, approved 1935, provides among other things for the elimination of improper practices in the liquor industry.

The Bituminous Coal Conservation Act of 1935, which seeks stabilization of the soft-coal industry, contains certain provisions dealing with price fixing and unfair methods of competition.

Acts excepting special groups from operation of anti-trust laws.—Several statutes have been passed which in effect relieve to some extent the following groups of businesses from the prohibitions of the anti-trust laws. trade unions, shipping companies, marine insurance companies, railroads, telephone companies, export associations, and agricultural associations.

The Sundry Civil Appropriations Act, effective July 1, 1916, and subsequent sundry civil bills, have contained provisions directing that money shall not be used to prosecute labor associations and farmers' associations the purpose of which is *lawfully* to increase wages, shorten hours, better conditions, and maintain fair and reasonable prices for commodi-

ties.[25] The right of employees to organize and bargain collectively is sanctioned by the Clayton Act; the Railway Labor Act as amended in 1934; the Anti-Injunction Act, commonly known as the Norris-La Guardia Act, passed in 1932, the National Labor Relations Act, passed in 1935; and the Bituminous Coal Conservation Act of 1935.

Under the Shipping Act of 1916, steamship companies may, through concerted action, do things which are prohibited to other companies by the anti-trust laws. Thus the act recognizes the practice of steamship companies of entering into agreements for apportioning traffic, fixing rates, and making similar arrangements, and exempts such agreements from the anti-trust laws if they are filed with the Shipping Board.

The Webb-Pomerene Act, approved April 10, 1918,[26] "directly repeals the Sherman Law in so far as export business is concerned."[27] The Edge Act, approved December 24, 1919, permits the organization under Federal charter of corporations for financing foreign trade.

Under the Merchant Marine Act of 1920, marine insurance companies may form combinations "to transact a marine insurance and reinsurance business in the United States and in foreign countries and to reinsure or otherwise apportion among their membership the risks undertaken by such association or any of the component members." Combinations may be made without control by any regulating body.

The Transportation Act of 1920 permits railroad consolidations with the approval of the Interstate Commerce Commission. Relief from the operations of the anti-trust laws is provided to some extent under the Emergency Transportation Act of 1933 and under the Motor Carrier Act of 1935. Consolidation of telephone companies is permissible

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[25] *Annals of the American Academy of Political and Social Science*, March, 1919 (Vol LXXXII) page 222 It is submitted that a careful reading of the provision of the acts referred to will reveal practically no direction to the Department of Justice except such as a reasonable interpretation of the anti-trust law had already suggested.

[26] The first and most important association formed under this law (December 17, 1918) was that of copper producers; the corporation had $250,000 of 7 per cent preferred stock and 500 shares of common stock of no par value Each producer who joined the association received one vote for each 500 tons of copper produced for export in the preceding twelve months

[27] *Annals of the American Academy of Political and Social Science*, March, 1919 (Vol. LXXXII), page 223

with the consent of the Federal Communications Commission, under the Communications Act of 1934

Combinations of persons engaged in agricultural production, through the formation of co-operative marketing associations on a mutual benefit plan, are permitted by the Capper-Volstead Act of 1922. The Secretary of Agriculture has jurisdiction over these organizations and may determine whether the practices of any such association monopolize or restrain trade in interstate or foreign commerce to such an extent that the price of any agricultural produce is unduly enhanced thereby. These organizations have been further encouraged by such legislation as the Cooperative Marketing Act of 1926, and by the creation of the Federal Farm Board.

Trade associations and the anti-trust laws.—As was indicated on page 613, the movement toward larger business units has made great progress since 1915. Along with the tendency toward amalgamation has come the development of the trade association.[28] A trade association is an organization within an industry, the object of which is to improve industrial and commercial efficiency. The Supreme Court of the United States has put its stamp of approval on these organizations in decisions rendered in two cases in which trade associations were attacked as organizations engaged in unlawful restraint of commerce. The Court recognizes as legal the practices pursued by trade associations in their co-operative movement, where the concerted action does not result in arbitrarily lessening production or increasing prices.[29] These practices generally include the promotion

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[28] According to a 1938 survey of the United States Department of Commerce, there are 8,200 trade associations in the United States, of which 2,400 are national or interstate For complete information as to trade associations, see Department of Commerce, "Selected Trade Associations of the United States," 1937 Ed , "Trade Associations," published by the National Industrial Conference Board, B S Kirsh, "Foreign Trade Functions of Trade Associations"; Kirsh and Shapiro, "Trade Associations in Law and Business "

[29] Maple Flooring Manufacturers Association v U S (1925) 268 U S 563. The following excerpt from the opinion in this case shows the attitude of the court toward trade associations when considering them in the light of the anti-trust laws. "We decide only that trade associations or combinations of persons or corporations which openly and fairly gather and disseminate information as to the cost of their product, the volume of production, the actual price which the product has brought in past transactions, stocks of merchandise on hand, approximate cost of transportation from the principal point of shipment to the points of consumption and who meet and discuss such information and statistics without ever reaching or attempting to reach any agreement or any

of commercial and industrial research, aid in the settlement of labor disputes, the making of arrangements for co-operative insurance, representation of particular industries in public disputes, collection of statistical information as to cost of production and as to prices at which products have been sold, recommendations of methods of cost accounting within an industry, and similar co-operative action tending to improve competitive conditions.

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concerted action with respect to prices or production or restraining competition, do not thereby engage in unlawful restraint of commerce" See also Cement Manufacturers Protective Association v U S, (1925) 268 U S 588 In a more recent case dealing with the question of price-reporting services of trade associations, the Supreme Court held that an effort to prevent unfair competition by an agreement, the distinctive feature of which is not the advance announcement of prices or concerted activity of maintaining any particular base price for any period, but rather a requirement of unqualified adherence to the prices and terms so announced, impairs the resources of fair competition in a manner violative of the Sherman Anti-Trust Act Sugar Institute v U S, (1936) 297 U S 553, 56 S Ct 629

CHAPTER XXXIII

CAUSES OF FAILURE

Diseases—causes and remedies.—The term "failure," when applied to a business enterprise, may suggest to the layman anything from inability to earn a profit, to a complete liquidation of the assets followed by a final discharge in bankruptcy. In ordinary business parlance, terms indicative of financial disturbances in a business are used indiscriminately and may or may not convey the legal or even accepted meaning of the word.

The same confusion will arise in the mind of the reader unless at the outset he has a clear understanding of the nomenclature of the subject. The careful student should distinguish between diseases, causes, and remedies. We shall proceed first to outline the nomenclature, giving definitions where necessary, and then shall proceed in this chapter to a more extended discussion of financial diseases and their causes, leaving a complete discussion of remedies to the next chapter.

Financial diseases.—A company may be said to be prosperous when it is able to meet all its obligations as they mature, and to pay a reasonable return on the investment, with something over to provide for growth and for the shortcomings of poor years. If a concern does not meet these requirements, it may be said to be unsuccessful. There are four stages of financial failure, each of which represents some degree of adversity. They are: (1) embarrassment, (2) financial insolvency, (3) total insolvency, (4) confirmed insolvency.

(1) *Financial embarrassment* has been judicially interpreted to mean that a concern is "encumbered with debt, beset with urgent claims and demands, and unable to meet pecuniary engagements." Probably this definition is too strong. We should say rather that a concern is financially embarrassed when it is in an unusual and unhealthy condition, which may be temporary, depending on the nature of the causes and the possibility of obviating them. It is a slight degree of illness which, if not remedied, will lead to the more

serious disease of insolvency. The causes leading to failure have not been operating long enough to cause either financial insolvency or total insolvency, but they will lead to one or both of these conditions if a remedy is not applied.

(2) *Financial insolvency* is that condition in which a concern finds itself when it cannot meet its debts as they mature in the ordinary course of business. The essence of the trouble is an excess of immediately maturing liabilities over the means with which to meet them.

(3) *Total insolvency* arises whenever a concern has an excess of total liabilities over total assets. If the concern is incorporated, the capital stock need not be included as a liability.

(4) The term *confirmed insolvency* is used here to indicate the failed condition of a concern against which legal steps have been taken or which itself has taken legal steps to satisfy claimants against its property. The legal steps which may be taken ordinarily are (a) an adjudication in bankruptcy, (b) appointment of a receiver because of financial insolvency, (c) assignment for the benefit of creditors. Since these steps are the first move in the application of the remedy to a failed concern, they will be taken up at greater length in the chapter on remedies.

Illustrations of embarrassment, financial insolvency, and total insolvency.—Consider the following three balance sheets:

Assets	*Company A*	*Company B*	*Company C*
Real estate and buildings	$100,000	$100,000	$100,000
Machinery, furniture, and equipment	40,000	40,000	40,000
Inventories	100,000	30,000	100,000
Accounts receivable	60,000	180,000	25,000
Cash	5,000	5,000	5,000
Deficit	145,000		30,000
Total Assets	$450,000	$355,000	$300,000
Liabilities			
Stock	100,000	100,000	100,000
Bonds	200,000	100,000	50,000
Accounts payable	150,000	100,000	150,000
Surplus		55,000	
Total Liabilities	$450,000	$355,000	$300,000

One of these companies is totally insolvent—and only one; one is financially insolvent; and one is only embarrassed.

Since company *A*'s liabilities (exclusive of capital stock, which for this purpose is not strictly a liability) exceed its assets by $45,000, the company is hopelessly insolvent and faces the bankruptcy courts. Company *B* has considerably more assets than liabilities; it is not totally insolvent. It has $185,000 of liquid assets, excluding entirely its inventories,[1] as against $100,000 of liquid liabilities. We assume, of course, that the bonds are long-term bonds and that the company can pay the interest on them, so that they will not mature for some time to come. Clearly, company *B* is not even financially insolvent. But probably it is embarrassed. Its inventories are low and it will need to replenish them. Its payables are high, showing that the company has probably been doing a very large business on inadequate capital. Its current debts are very large, and probably many of its creditors are clamoring for cash. The extent to which company *B* is embarrassed may be better appreciated if we assume that the company could raise $100,000 through the sale of bonds, and if we contrast the balance sheet as it would then appear with the balance sheet as it now stands

Company *C* is clearly financially insolvent. It has current liabilities of $150,000 against current assets of $130,000, assuming, for the present, that all its inventories are liquid.

A study of the following two balance sheets will still further elucidate the meaning of the terms under consideration:

Company X[2]

Assets	
Railroad right of way, structures, and cars	$31,038,837.55
Cash, accounts, receivables, supplies	776,091 02
Special deposits and investments	525,336 62
Deferred debit items and suspense accounts	187,473 74
Corporate deficit	2,805,664 87
Total assets	$35,333,403 80

[1] Should inventories be included here in liquid assets? Should inventories ever be included among liquid assets? The liquidity of assets is a question of fact and not of rule The test of fact that may be applied is those assets are liquid which may be turned into cash within a reasonably short period without sacrifice of value Much will depend on the general nature of the business and the nature and condition of the assets listed in the inventories. (See the chapters on working capital)

[2] The balance sheet of company *X* is a condensed actual balance sheet; that of company *Y* is imaginary.

Liabilities	
Capital stock	4,945,250 00
Funded debt	21,200,000 00
Floating debt	9,152,492 21
Reserves	35,661 59
Total liabilities and capital	$35,333,403.80

Company Y

Assets	
Real estate, plant, and machinery	$5,000,000 00
Cash, accounts, and notes receivable	200,000 00
Inventories	1,300,000 00
Deficit.....	1,500,000 00
Total assets	$8,000,000 00
Liabilities	
Stock	$1,000,000 00
Bonds	6,500,000 00
Accounts and notes payable	100,000 00
Reserves	400,000 00
Total liabilities and capital.	$8,000,000 00

Here, company *X* is strictly not totally insolvent, since the total of assets is in excess of the total of liabilities. This statement may not seem true at first glance, since there seems to be a "corporate deficit." But in calculating the insolvency of a company under the Bankruptcy Act, stock is not a liability—it is what the accountants call an accountability Still, company *X* is financially insolvent since it has a net floating debt, that is, quick liabilities in excess of quick assets, of over $7,500,000. It is only because this company happens to be a subsidiary of another corporation that it can finance its immediate obligations and that it is not in the hands of a receiver.[3] Company *Y*, on the other hand, is totally insolvent; it is not, however, financially insolvent, since it has $200,000 of quick assets with which to meet $100,000 of quick liabilities. If company *Y* has good earning power, it may be able to pay all its debts promptly, including interest on its bonds. The secret here is that if the company really has an exceptional earning power, it is entitled to show it on its balance sheet through an entry called "goodwill" appearing on the assets side, sufficient in amount to wipe out the corporate deficit.

[3] We shall see later, page 756, that railroad companies do not go into voluntary or involuntary bankruptcy

Classification of causes of failure.—The causes of failure may be divided generally into two classes, those operating from the outside and those operating from the inside. The outside causes are those which may possibly be obviated but ordinarily cannot be eradicated They include competition, change in demand for the products of the company, the operation of the business cycle, and casualties. The inside causes are all summed up in the two words, "incompetency" and "fraud." The forms of incompetency and fraud we shall take up specifically, after discussing briefly the three outside causes of failure.

Competition.—Competition up to a certain point is stimulating; beyond that it is exhausting. This is not the place to discuss that statement.[4] Nor is this the place to discuss at length the strategy of competition. We must content ourselves with the statement that oftentimes competition is disastrous because businesses take it too seriously. If a concern begins to think more about eliminating competition than it does about making profits through better production and selling plans, then competition does become a menace. If conditions are such that profits are humanly impossible because of competition, only two options are open: (1) combine with the competitors; (2) liquidate and withdraw from the field.

Change in demand for the products of the company.—Changes in the demand for a company's product may lead to failure. We need hardly do more than give illustrations. The failure of the American Bicycle Co in 1902, was due largely to the cessation of a fad.[5] A number of brewery companies were compelled to liquidate on account of the Eighteenth Amendment.[6] These two outstanding examples of changes in demand have led American business men to insist upon the accumulation of large reserves with which to enable a company to change its product when the need arises. The stronger businesses in the brewery field, for example, met their difficulties by adapting their machinery to the manufacture of chemicals and unprohibited beverages.[7]

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[4] See *ante*, pages 317 and 624

[5] See A. S. Dewing, "Corporate Promotions and Reorganizations," page 249.

[6] American Malting Corporation is a good example

[7] The *Wall Street Journal* for October 11, 1918, carried this paragraph among others about Distillers Securities Corporation· "Meantime, it is developing its industrial lines in various directions. One of its subsidiaries, for instance, is

Operation of the business cycle.—Economists are not yet agreed on the causes of the movements noticed in the so-called business cycle. We know in a general way that for a number of years prices and the demand for goods will increase simultaneously. Then will come a reaction, accompanied by a marked lowering of prices and a noticeable restriction in demand. This period of reaction will be followed by another period of depression, during which prices will remain low and the demand for goods will be relatively slight.

During a period of rising prices, profits for most businesses will increase. During a period of reaction, definite losses will be incurred through the failure of customers and through the inability of the company to keep all its organization at work. Salesmen cannot sell goods, and they therefore have to be "let out"; the restricted demand for the company's product will necessitate "laying off" employees Thus the organization is disrupted and considerable expense will be involved in rebuilding when business conditions improve. Moreover, some businesses fail during periods of reaction because the decline in prices attending such periods involves them in inventory losses that are beyond the company's financial strength to endure. If a business is not strong enough to withstand the losses of these periods, it will fail. During the period of depression that follows the reaction, business may be so slack and prices so low that expenses of all kinds cannot be met out of current income, but must be defrayed from accumulated funds. A corporation that follows a conservative reserve policy can apply the ounce of prevention that is much more effective than a pound of remedy.[8] Companies whose directors use foresight in forecasting the business cycle, and make provision for the inevitable periods of reaction and depression, usually can weather the storm. They enter the next period of prosperity scarred, perhaps, but not broken.

Casualties.—The causes of trouble may be entirely fortuitous. Lawyers call them "acts of God," but in these days we must add "acts of the sovereign." For example, the enactment of the Seamen's Law in 1915, requiring 75 per cent of the crew in each department of a vessel to be able to under-

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making candied cherries, and apple, peanut and peach butter on a big scale And Distillers' chemists have a lot of tricks up their sleeve for use after the war."

[8] See *ante*, pages 461 and 582.

stand any order given by the officers, made it impossible for American vessels to compete with Japanese vessels, on which Asiatic crews could be employed. The Pacific Mail, in the face of this casualty, proceeded to liquidate, and was revived only when the European War changed conditions and permitted the company to make profits even under the handicap.

The obvious remedy for difficulties arising from "acts of God" is to insure against them through reserves or through policies taken from insurance companies.[9] Where the casualty is due to an act of the sovereign, the remedy is, first, to exercise the prerogative of a citizen to influence legislation, and second, to reduce losses to a minimum by being prepared to change the nature of the business or to liquidate its assets and liabilities under the most favorable terms. Here the rule is: forewarned is forearmed.

Incompetence the chief cause of failure.—Perhaps all the inside causes (other than downright chicancry) may be summed up in one word, "incompetence." In fact, the same may be said of outside causes, for with good management the evil effects of most of these causes can be nullified, if the causes themselves cannot humanly be avoided. Take, for example, the most excusable of all outside causes—casualties such as fire. Some concerns withstand huge fire and other losses successfully, while others fail. The fact is that many casualties can be provided against. Insurance should be one of the legitimate costs of conducting a business. Crop failures may injure nearly all the customers of a given concern and in that way involve the concern, very indirectly, to be sure, in ruin. But the connection between a crop failure and the fortunes of customers, and the effect of such a failure on the concern's fortunes, should have been taken into the reckoning. Moreover, the possibility of a crop failure is never so remote a contingency that it can be neglected by those whom it may affect. And finally, crops do not fail in a day; information about crop prospects is always available.

When we come to the inside causes of failure, such as archaic methods of production, slowness of collections, and unwise distribution of cash dividends, we have less difficulty in laying the blame where it belongs—at the door of incompetence. Competent supervision of production will not toler-

[9] See *ante*, page 586.

ate obsolete production methods. Collections are slow either because the credit department has not been competent in the granting of credits, or because the collection department has not yet learned that vigilance is the *sine qua non* of successful collections One who has read the chapters preceding must realize that the principles there laid down are the product of common sense applied to the conduct of ordinary business operations.[10]

Other causes arising from conduct of the business.—The causes arising from inside the business may be classified as follows:

I. Poor management in departments other than financial.
  A. Inadequate revenues due to
    a. Poor promotion.
    b Incompetent sales organization.
    c. Poor quality of product.
  B. High operating expenses, due to
    a. Improper organization.
    b. Neglect of details of management.
    c. Unprofitable products.
    d. Archaic machinery and production methods.

II. Financial management.
  A. Overcapitalization, arising out of
    a. Poor financial plan.
    b. Bad marketing of securities.
    c. Poorly timed sale of securities.
    d. Issuance of securities to obtain unprofitable subsidiaries.
  B. Excessive floating debt, arising from
    a. Acquisition of fixed assets through use of short term credit.
    b. Overexpansion of business without provision for new working capital.
    c. Incompetent credit and collection department.

[10] A statement of the U S Department of Commerce (Series No 69) showing owners' and creditors' opinions of the causes of failure of 570 bankrupt enterprises in Boston, Mass , 1930–31, reveals that, in the opinion of creditors, 58 7 per cent of 516 failures was due to inefficient management Twenty-two other reasons for failure are noted, many of which may be regarded as due to incompetence

d. Lack of adequate banking facilities, resulting in high cost of borrowing current funds

e. High cost of obtaining working capital.

C. Exhaustion of funds through pursuance of unwise dividend policy.

D. Failure to make adequate provision for maintenance.

III. Fraud, associated usually with reprehensible accounting practice.

The classification given above was arranged in tabular form so that in any given case the symptoms that common sense tells us are associated with the causes might be observed, and where possible, the causes themselves eradicated. Some of the causes deserve more extended consideration.

Inadequate gross revenues.—As every one knows who is at all familiar with the income statements of corporations, the success of a business generally depends upon the revenues it receives from customers. Inadequate revenues may be inevitable because the business was started in a barren field. For example, the New York, Westchester & Boston Railroad was built to run northeast from 138th Street in the City of New York. Its cost was tremendous—something like $2,000,000 a mile. The territory it served was the most sparsely settled part of the environs north of New York City. The result has been a loss that would have overwhelmed the company had it not had the resources of the New York, New Haven & Hartford R. R. to sustain it.[11] The gross revenues may be limited either because in the first instance, as in the case of the New York, Westchester & Boston, the market originally chosen was inadequate, or because the market has been subsequently narrowed by a shifting of trade centers. The Colorado Midland Ry. was compelled to cease operations on August 4, 1918, on account of the exhaustion of the mines in the district served by the road. Only 15 per cent of the company's business at the time of failure was local. This company probably should have courageously faced the situation years before and closed out its business at that time.

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[11] See chapter on promotions, page 20.

Another notable example of this cause of failure is the H. B. Claflin Co., an old concern in New York engaged in the wholesale dry goods business Retail units in the dry goods field had become so large, through the growth of department stores and the establishment of chain stores, that they could buy from the manufacturers on as good terms as could the wholesalers. Why, then, give the wholesaler a price that covered an additional profit over and above the manufacturer's price? To meet the situation, the Claflin house started a chain of retail stores of its own. But these, of course, could not compete fairly with local rivals that did not have to pay a wholesaler's profit. The Claflin Co. should have organized the chain of retailers, but instead of making them tributary, should have liquidated its wholesale business and confined its attention to the chain-store business.

Sometimes the revenues are inadequate because the marketing department is incompetent. And again, the disappearance of business may be attributed to the production of an inferior commodity or service that people will not buy when there is an option to buy a competing product, or without discomfort, to go without the product entirely.

On the other hand, the market may be fertile enough, but the company may have inadequate means of reaching it or may be attempting to supply it with a product somewhat different from that which the market demands. The trouble here may be laid at the door of the sales department.

To meet conditions of failure arising from all these causes requires the application of methods a description of which is not within the scope of this book.

High operating expenses.—The trouble may be located in the producing departments, whence probably the difficulty may be still further traced to financial delinquencies. Leaky locomotives are likely to be the result of insufficient equipment which necessitates the constant use of a few locomotives that should be laid up for repairs. Failure to substitute "machinafacture" for the more costly hand production may, to be sure, be the result of "old fogy" inertia, but it is more likely to reflect the need for funds with which to buy modern machinery. The curse of the poor is their poverty.

To be sure, other causes may operate in the production department to bring about destruction. Uncoördinated organization, over-organization, poor buying, antiquated

methods of handling goods in process—such things may be the evident signs of a generally run-down, mismanaged concern. Business is always a shirt-sleeve affair, and unless some one with responsibility and interest is in charge of the important posts and is always ready to watch the myriad of details that make up any enterprise, waste will eat up the profits.

Overcapitalization.—We have just discussed causes that may operate continuously but that can readily be obviated by good management. The record of adversity arising from these causes is found in the income statement of a business; gross revenues are low or operating expenses are high. We now come to a cause of failure that is carved right into the structure of the business itself, one that is revealed in the balance sheet, and one that can be obviated only by a recasting of the capitalization. If the troubles described in the preceding sections can be said to be maladies responding to ordinary medical aid, this trouble is organic, and requires an operation. And to carry the simile further, if the people interested in the company will agree to a recasting of the capitalization, the operation will be a minor one; but if a voluntary agreement cannot be arrived at, then a major operation, involving the services of a court, will be required.

Overcapitalization exists in its most imminently dangerous form when the company is overloaded with bonds, for then if interest is not paid, the creditors may proceed to involve the company in legal proceedings. But overcapitalization consisting of a redundancy of stock is also dangerous. In the first place, the directors are inclined to pay dividends on the overcapitalization, thus stripping the company of needed funds Or if this is not done, the company presents the spectacle of a corporation that cannot pay dividends, and it therefore probably cannot expand through the sale of stock. What credit it does get it must pay for dearly.[12] Overcapitalization, it can be seen, is a serious disease.

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[12] The trouble becomes doubly serious when there are several classes of stockholders, each jealous of the other and each unwilling to give ground The American Hide and Leather Co is a good example. Between 1899, when the company was reorganized, and 1921, the earnings, while substantial, were very largely used in the payment of interest and installments on the principal of $1,500,000 mortgage bonds, issued at the time of organization, all of which were paid off and retired. For that reason dividends on the preferred stock were to a great extent left unpaid and they accumulated to the point where in 1925 they amounted to approximately 140 per cent of the total preferred

As the above outline indicates, the disease may arise from a poor financial plan—or, as is more likely, from the entire absence of a plan. Companies continue to grow, interesting themselves principally in ordinary business problems and treating the financial problems as extraordinary occurrences to be settled by the application of the most convenient expedients. Anything that is done will be justified by future earnings. Moreover, since most financial operations are undertaken in the flush of unusual prosperity or in the depths of unusual adversity, the same care is not observed in making financial plans that would be used under normal circumstances. The promoter, for example, is a blind optimist, and the directors of a carelessly-managed company are like drowning persons catching at straws.

Overcapitalization often arises from unprofitable expansion, or from expansion improperly carried out. The receivership that closed one of the periods in the history of the Westinghouse Electric and Manufacturing Company in 1907, furnishes us with a rare example of unprofitable expansion. Here the expansion was the result of the directors' craze for foreign markets. The luckless career of the American International Corporation, which in 1915 was enabled to step into full-panoplied existence because the interests that sponsored it were able readily to place its relatively large capitalization, teaches us the lesson that time is a necessary element of growth; a company cannot expand effectively by simply spending money. For an example of unprofitable expansion, unprofitably carried out, we naturally turn to the story of the New Haven road. So ineffective were the means used in buying up traction lines that an action for malfeasance was brought against the directors, who paid $2,000,000 to the company to settle the suit. Among more recent failures due to overexpansion of fixed assets are those of Fox Film and Paramount-Publix, both of which acquired theater chains at

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stock outstanding Several attempts to readjust the capitalization failed, because the common stockholders would not consent to an adjustment that placed their equity in the property at practically nil Finally, in 1925, a readjustment plan that provided for reclassification of the preferred shares, extinction of the accrued dividends, and a reduction of the capital stock to be accomplished by a cancellation of unissued shares of preferred and common stock and a retirement by purchase of part of the outstanding preferred stock, was approved by the stockholders For later difficulties of this Company, see page 138.

excessive cost during the "boom" period. In fact, overcapitalization and overexpanded fixed assets and productive capacity caused many of the failures in the early thirties.

It will be noticed from the outline that the causes of overcapitalization include wrong methods applied to the "what," the "how," and the "when" of the problem of capital issue. A thoroughly typical example of overcapitalization arising from mistakes in solving all three problems of what, how, and when, is furnished by the old 'Frisco. In 1896 its capitalization of about $81,000,000 consisted of about 45 per cent bonds and 55 per cent stock. By 1913 the capitalization consisted of only $51,000,000 of stock and $296,000,000 of bonds. The ratio of stock to bonds was as 17 to 83. During that period, commissions and discounts on the sale of securities amounted to $32,152,602.07, about one-seventh of the amount of capital obligations assumed. Moreover, the panic of 1907 held few terrors for the directors, who continued to increase their obligations.

Excessive floating debt.[13]—Perhaps most failures reveal lack of working capital as their direct cause. However, lack of working capital is hardly a cause—it is a symptom; the causes are more deeply seated. Current funds may dwindle away simply because a company is operating at a loss. These fundamental causes we have already discussed. There are, however, other causes that operate directly to exhaust working capital.

Companies frequently go on expanding out of profits, making commitments in the purchase of assets that ought to be furnished from fresh funds obtained through the sale of stocks or bonds.[14]

As the fixed assets increase, the business itself expands and more funds are required for working capital. For example, goods are sold by salesmen on sixty days' credit. Every sale made by the salesman probably involves an outgo of funds, equal to one-fifth of the amount of the sales, two or three months before any cash is received from the sale, because salesmen's commissions are usually paid when the sale is made. Moreover, additional cash is required to make and ship the

[13] Floating debt simply means current liabilities, though it connotes that part of current liabilities which, if the company were in a sound condition, could be funded into long-term obligations

[14] See C W. Gerstenberg, "Materials of Corporation Finance," page 929.

goods. Therefore, as business increases, the outflow of cash tends to keep ahead of the inflow. It happens, of course, that businesses do most of their increasing in the months following a period of general depression, during which the effort to keep the organization together usually involves a heavy drain on cash resources. Moreover, as was indicated above, as a business expands, the demand for fixed assets increases, and the directors are likely to lose their good judgment in the exuberance of prosperity and to permit current funds to be turned into fixed assets. The causes operating to lay a company low through a depletion of working capital are indeed insidious.[15]

When a period of prosperity overtakes a company, and new orders pile up, the credit department is likely to lose some of its caution. Collections will be permitted to drag because the volume of collections is large, absolutely though not relatively. Competent credit men know how important it is to keep collections up to the minute—to "get the money while the getting is good." When the period of prosperity reaches its crest and reaction sets in, the careless concern's own creditors will be more insistent for prompt payment, and its dilatory debtors will postpone payment with the excuse that apparently the concern does not need the money badly or it would have tried to collect the account when it was due.

A more insidious cause of failure growing out of the use of current funds to build up fixed capital, is the lack of foresight of promoters and managers in providing funds for building up intangible assets. A publisher of a country newspaper, for example, sent the author a letter just as this chapter was being written. He had taken over an old paper that had been run at a loss, and hoped by applying modern methods to make the paper a paying concern. But his letter contains this sentence, "If I can stand the gaff long enough, I believe we will have a winner in time." What he means is, "If I can supply the funds to preserve and create the 'going concern value' of the newspaper while I am building up 'goodwill,' we shall ultimately succeed."[16] Or, to put the publisher's problem in words that he himself would be more likely to use if he were asked to explain his statement about "standing the gaff," we would say, "If my own funds, or the funds that

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[15] See relation of business cycle to working capital, pages 328 *et seq.*

[16] See the definitions of these terms contained in the chapters on promotion, page 14.

I can raise, will hold out, while I publish the paper for a number of weeks till I can get good, active correspondents who will send in news that will interest a larger circle of readers, and thus help to increase the circulation, on the basis of which I can increase the amount and price of my advertising, I shall have a winner." It will be seen that the problem is a double one: not only how much funds are on hand, or can be raised, but how quickly the "going concern value" and "goodwill" can be built up. Some estimate should be made of these two unknown quantities, and the funds which that estimate shows will be needed to build up the intangible assets should be in sight; it is the height of folly to trust to luck, hoping that net earnings will provide them.

No mistake is worse than that of neglecting to use banking facilities. In the first place, a concern that does not borrow from a bank is sometimes treated by creditors as not being able to persuade a bank that the risk is good. In the second place, a concern that does not regularly use banking funds will be regarded with extreme suspicion by the bank when it does apply for a loan.[17]

One of the great difficulties of inadequate working capital is that the disease tends to aggravate itself. When funds are short, almost any price is paid to get enough currency to postpone the day of reckoning. The expedient only serves to hasten that evil day and to increase its ills. For example, in 1913 the M. Rumely Company (since reorganized into the Advance-Rumely Company) borrowed $4,000,000 from bankers and gave as security over $8,000,000 of customers' notes. These latter, of course, should have been available in addition to the loan, but as they were paid by customers the proceeds went to the bankers and thus the company was cut off from its regular income.

Unwise dividend policies.—When a company needs funds, one of the first steps thought of to encourage investment is to raise the dividend rate, or to pay dividends if none have previously been paid. In 1921 the American Telephone & Telegraph Company raised its rate from 8 to 9 per cent preparatory to an issue of $150,000,000 of stock. That was good business because the rate of dividends was justified by the company's earnings. But when the rate of dividend is not justified, disaster is sure to follow. The troubles of many

[17] See generally the chapters on working capital.

railroads in the dark years of 1873 to 1898—Erie, Baltimore & Ohio, and Atchison—can all be laid at the door of dividend distributions that were not earned. One of the basic causes of the failure of Studebaker Corp. in 1933 was the continuation of a liberal dividend policy at a time when the company was losing its trade position and embarking upon a program of expansion of fixed assets in order to regain it. Earnings were not sufficient to permit expansion, meet an additional costly overhead, and still allow a continued liberal dividend policy.

Inadequate maintenance.—In striving to get the funds with which to pay unearned dividends, the company is apt to neglect the investment of the owners. The 'Frisco trouble referred to on page 738 was aggravated by the fact that the company was trying to compete with other roads when its equipment was so far from being one hundred per cent efficient that the receiver shortly after his appointment crossed thirty thousand cars off the books as worthless.

Improper accounting methods—Almost always, an unwise dividend policy is based on a false statement of condition conceived in the minds of delinquent executives and born in the offices of the accounting department. For example, Mr. Stephen Little, perhaps the leading accounting expert of a generation ago, in 1896 made a report on the Baltimore & Ohio covering the accounting aspects of that road's troubles leading to a receivership. He showed that the following errors had been made over a period of about seven years.[18]

An overstatement of net income	$2,721,068
A mischarge of worn-out equipment to profit and loss	2,834,596
Improper capitalization of expenses, main stem	2,064,741
Improper capitalization of so-called improvements, leased and dependent lines	3,575,453
Total overstatement of income	$11,195,858

It will be noticed that the greatest error was made where it would be least noticed, in the accounts dealing with subsidiaries.

Generally, the inaccuracy of the accounts is intentional and the management is thoroughly aware of the true condition. The failure of the Siegel-Cooper stores in 1914 brought to

[18] S. Daggett, "Railroad Reorganization," pages 21–22

light the fact that a system of falsifying accounts and keeping a secret set of books containing the true figures had been in vogue in the Boston store. The intentional "doctoring" of accounts serves the purpose of keeping the stockholders optimistic or of improving the possibility of securing additional loans. The statements on which the Simpson-Crawford Company, which was owned by the Siegel Stores Corporation, received additional loans from banks, were absolutely false, the firm's figures showing in one case a surplus of $817,000 when the company actually had a deficit of about the same amount. Books can be made to show almost any condition desired to be shown, and reports can be drawn up in such a way that though they do not portray the actual condition, they are not false Often the irregularity that is hidden consists of carrying the stocks of weakling subsidiaries in the balance sheet at cost plus all the losses attributable to these fungi. The balance sheet of H. B. Claflin & Co. for 1913 was good throughout, but the statement gave no account of intercorporate relations and while the parent company was apparently solvent, practically all the retail stores which the company was financing were insolvent.

The improper practice of treating stock dividends as cash income was one of the contributing causes to the failure of the Insull pyramid of Middle West Utilities Co. Another was the excessive advances to and investments in subsidiaries.

The accounting of a manufacturing concern should provide for a cost system. This is especially desirable where several units are being produced, for then the management can readily determine which article is yielding a profit and which is resulting in a loss.

Statistics of failures.—Attempts to collect statistical information on failures have been left mainly to the credit agencies; the most comprehensive tables have been prepared by Dun & Bradstreet, Inc. As in all statistical work, unless the unit of measurement is unmistakably named and defined, statistical tables cannot be interpreted. In the tables of commercial failures following, a business failure is deemed to have occurred when a commercial or industrial enterprise is involved in a court proceeding or a voluntary action which is likely to end in loss to creditors. Specifically, the Dun & Bradstreet record of failures includes discontinuances following assignment, voluntary or involuntary petition in bank-

ruptcy, attachment, execution, foreclosure, etc.; voluntary withdrawals from business with known loss to creditors; enterprises involved in court action, such as receivership, and since June, 1934, reorganization, or arrangement, which may or may not lead to discontinuance; and businesses making voluntary compromises with creditors out of court.

TABLE No 14

RECORD OF INSOLVENCIES

(From tables prepared by Dun & Bradstreet, Inc)

Year	*Number of failures*	*Total liabilities**	*Number in business*	*Percent failing*
1938	12,836	$246,505,000	2,102,000	61
1937	9,490	183,253,000	2,057,000	44
1936	9,607	203,173,000	2,010,000	50
1935	12,244	310,580,000	1,983,000	60
1934	12,091	333,959,000	1,974,000	62
**1933	19,859	457,520,000		
1933	20,307	502,830,000	1,961,000	1 04
1932	31,822	928,313,000	2,077,000	1 53
1931	28,285	736,310,000	2,125,000	1 33
1930	26,355	668,283,842	2,183,008	1 21
1929	22,909	483,252,196	2,212,779	1 04
1928	23,842	489,559,624	2,199,000	1 08
1927	23,146	520,104,268	2,171,700	1 09
1926	21,773	409,232,278	2,158,400	1 01
1925	21,214	443,744,272	2,113,300	1 05
1924	20,615	543,225,449	2,047,302	1 01
1923	18,718	539,386,806	1,996,004	94
1922	23,676	623,896,251	1,983,106	1 19
1921	19,652	627,401,883	1,927,304	1.02
1920	8,881	295,121,805	1,821,409	49
1919	6,451	113,291,237	1,710,909	38
1918	9,982	163,019,979	1,708,061	.58
1917	13,855	182,441,371	1,733,225	.80
1916	16,993	196,212,256	1,707,639	1 00
1915	22,156	302,286,148	1,674,788	1 32
1914	18,280	357,908,859	1,655,496	1 10
1913	16,037	272,672,288	1,616,517	99
1912	15,452	203,117,391	1,564,279	99
1911	13,441	191,061,665	1,525,024	88

* The figure of liabilities is primarily one of current indebtedness, especially since the elimination in 1933 of certain types of business tending to have heavy deferred obligations For the purpose of the failure record, current liabilities are understood to include not only all accounts and notes payable, but also all obligations, whether in secured form or not, known to be held by banks, officers, affiliated companies, supplying companies, or the government

** In 1933, failures of all real estate, insurance, holding, and financial companies, and of such concerns as steamship lines, travel agencies, amusement places, etc , were eliminated from the record because of incomplete coverage in these fields, and in order to make the data more comparable with the types of concerns listed in the Dun & Bradstreet Reference Book This change resulted in lowering the 1933 total by 448 failures with liabilities of $45,310,000 In order to provide an overlap, both series are given in the tabulation.

TABLE No. 14 (Continued)
RECORD OF INSOLVENCIES

Year	*Number of failures*	*Total liabilities*	*Number in business*	*Percent failing*
1910	12,652	201,757,097	1,515,143	84
1909	12,924	154,340,000	1,486,389	80
1908	15,690	222,315,684	1,447,554	1 08
1907	11,725	197,385,225	1,418,075	83
1906	10,682	119,201,515	1,392,949	76
1905	11,520	102,676,172	1,357,455	84
1904	12,199	144,202,311	1,320,172	92
1903	12,069	155,444,185	1,281,481	94
1902	11,615	117,476,769	1,253,172	93
1901	11,002	113,092,376	1,219,242	90
1900	10,774	138,495,673	1,174,300	91
1899	9,337	90,879,889	1,147,595	81
1898	12,186	130,662,899	1,105,830	1 10
1897	13,351	154,332,071	1,058,521	1 26
1896	15,088	226,101,000	1,151,579	1 31
1895	13,197	173,196,060	1,209,282	1 09
1894	13,885	172,992,856	1,114,174	1 25
1893	15,242	346,779,889	1,193,113	1 28
1892	10,344	114,044,167	1,172,705	88
1891	12,273	189,868,638	1,142,951	1 07
1890	10,907	189,856,964	1,110,590	98
1889	10,882	148,784,337	1,051,140	1 04
1888	10,679	123,829,973	1,046,662	1 02
1887	9,634	167,560,944	994,281	90
1886	9,834	114,644,119	969,841	1 01
1885	10,637	124,220,321	919,990	1 16
1884	10,968	226,343,427	904,759	1 21
1883	9,184	172,874,172	863,993	1 06
1882	6,788	101,547,564	822,256	82
1881	4,735	81,155,932	781,689	71
1880	4,375	95,352,000	746,823	63
1879	6,658	98,149,052	702,157	95
1878	10,478	234,383,132	674,741	1 55
1877	8,872	190,669,936	652,006	1 36
1876	9,092	191,117,786	681,000	1 33
1875	7,740	201,060,333	642,420	1 21
1874	5,830	155,239,000	600,490	97
1873	5,183	228,499,000	559,764	93
1872	4,069	121,056,000	528,970	77
1871	2,915	85,252,000	475,145	83
1870	3,546	88,242,000	427,230	83
1869	2,799	75,054,000	352,674	.79
1868	2,608	63,694,000	278,840	.94
1867	2,780	96,666,000	209,720	1.33

Dun & Bradstreet's table showing the percentage of large failures to total failures for a series of years is given on the following page.

TABLE No 15

PERCENTAGE OF LARGE FAILURES TO TOTAL FAILURES

	All Commercial					
	Number			Liabilities		
	Total com'l	*$100,000 or more*	*% of total*	*Total com'l*	*$100,000 or more*	*% of total*
1938	12,836	283	2.2	$246,505,000	$106,385,000	43.2
1937	9,490	287	3.0	183,253,000	81,397,000	44.2
1936	9,607	322	3.4	203,173,000	100,370,000	49.4
1935	12,244	553	4.5	310,580,000	175,091,000	56.4
1934	12,091	670	5.5	333,959,000	195,450,000	58.5
1933	19,859			457,520,000		
1933	20,307	979	4.8	502,830,000	242,010,000	48.1
1932	31,822	1,625	5.1	928,313,000	495,688,000	53.5
1931	28,285	1,055	3.7	736,310,000	382,151,000	51.9
1930	26,355	947	3.5	668,283,842	364,818,359	54.5
1929	22,909	744	3.2	483,250,196	221,794,342	45.9
1928	23,842	689	2.9	489,559,624	224,599,775	45.9
1927	23,146	708	3.1	520,104,268	265,387,741	51.0
1926	21,773	610	2.8	409,232,278	171,617,704	41.9
1925	21,214	591	2.8	443,744,272	208,280,053	46.9
1924	20,615	650	3.2	543,225,449	300,344,383	55.3
1923	18,718	743	4.0	539,386,806	321,137,661	59.5
1922	23,676	868	3.7	623,896,251	323,842,826	51.9
1921	19,652	873	4.4	627,401,883	375,126,153	59.8
1920	8,881	453	5.1	295,121,805	191,808,042	65.0
1919	6,451	191	3.0	113,291,237	55,986,543	49.4
1918	9,982	230	2.3	163,019,979	81,562,965	50.3
1917	13,855	250	1.8	182,441,371	81,861,018	44.9
1916	16,993	216	1.3	196,212,256	66,507,589	33.9
1915	22,156	331	1.5	302,286,148	122,739,907	40.6
1914	18,280	409	2.2	357,908,859	210,715,947	58.9
1913	16,037	379	2.4	272,672,288	136,903,915	50.2
1912	15,452	276	1.8	203,117,391	76,578,086	37.7
1911	13,441	295	2.2	191,061,665	80,622,611	42.2
1910	12,652	260	2.1	201,757,097	103,275,788	51.2

Chapter XXXIV

RECONSTRUCTION OF CORPORATIONS

Difference between objects and methods in reconstruction.—When a business suffers from any of the troubles described in the preceding chapter, something must be done by way of remedy. Many remedies are available, all of which may be summed up in the one word "reconstruction"—a word borrowed from English practice and used here as a convenient generic term to cover all the remedies known in American practice.

At the outset, the reader should distinguish between the objects sought to be accomplished by a reconstruction, and the methods available for accomplishing those objects. After all, the main thing is to discover the causes and to know how they can be obviated. In many cases the causes suggest their own remedies; the objects of reconstruction are apparent. Since, however, a business in serious trouble usually has a number of claimants, remedies cannot be applied by simple negotiation. The methods to be used in achieving the objects of reconstruction are therefore not simple. The various classes of claimants must be organized; a definite line of strategy must be followed to persuade the claimants to make the concessions necessary to reach a plan that will obviate the causes of failure. In many instances a legal battle must be fought to force the acceptance of a reasonable plan of reconstruction.

Objects of reconstruction.—When a failing or failed concern is being treated for its malady, certain steps are usually taken which we shall study carefully under the heading of Methods of Reconstruction; but whichever method is used, the persons in charge of the reconstruction must have in mind the objects which their reconstruction is to accomplish. A general classification of these objects follows:

1. To obviate the causes of trouble.

2. To repair the damages caused by the trouble. In many cases directors are guilty of misfeasance or malfeasance and suits must be brought to recover the damages.

3. To satisfy claimants who are in a position to insist upon cash payment.

4. To provide a management that can successfully carry the concern through after reconstruction.

5. To provide new fixed assets where they are necessary, either to take the place of archaic assets, or to enlarge the business sufficiently to put it on a paying basis.

6. To provide necessary working capital and cash for the expenses of reconstruction.

7. To reconstruct the financial plan.

8. If the business is an economic failure, to liquidate it.

Obviating the causes of failure—In the preceding chapter we enumerated the causes of failure and in discussing them pointed out practicable measures by means of which they could in most instances be obviated. The best technique in reorganization is futile unless the plan of reorganization goes to the root of the trouble. The successive reorganizations in the early history of the Philadelphia & Reading Railroad furnish an apt illustration. This company failed three times between 1880 and 1895, and during that time was in the hands of a receiver for ten years. The Atchison, Topeka & Sante Fé Railroad went through three reorganizations, the first two of which were not accompanied by foreclosure. It probably ought to be added that in both cases the successive misfortunes were due in part to the continuing boldness of the directors of the reorganized companies in pursuing an old policy of expansion. But in both cases a more drastic reorganization would have helped the economics of the situation and probably would have chastened the spirits of the directors.[1]

In the industrial field, the American Writing Paper Co. and its successor, the American Writing Paper Corp., furnish examples of ineffective reorganization due to failure to remove fundamental weaknesses.

Repairing damages.—Obviously, few failures of corporations can be attributed to causes beyond the control of the directors. If it can be established that directors are per-

[1] The claim is made that today it is well-nigh impossible to reorganize some of the many railroads which went into bankruptcy during the thirties, after earlier reorganizations, so deep-rooted in the entire industry are the causes of failure. For example, the directors of the Chicago, Milwaukee & St. Paul, which was reorganized in 1928 and went into bankruptcy in 1937, claimed that the increase in wages and the incidence of social security and railroad retirement taxes so reduce the earnings available for interest as to make it impossible to reorganize the property See Investigation of Railroads, Holding Companies, and Affiliated Companies, (1939), p 5631. See also page 770.

sonally responsible for the causes leading to failure, they should be called to account in legal proceedings, in order that money will be forthcoming to make good the damage, as far as money is able to do so. The carelessness of stockholders in asserting their rights in this respect has become traditional. For example, the stockholders of the New York, New Haven & Hartford Railroad were notified in the annual statement for 1914 sent out to stockholders, that "counsel are also carefully considering whether, in the testimony obtained by the Commission or elsewhere, evidence can be found that will enable the Company to bring an effective suit against any other parties to recover funds alleged to have been improperly diverted from the Company's treasury." In 1915 an annual report was sent to the stockholders containing the statement that the suits for restitution were to be dropped by the directors, and the stockholders were notified that they would be given an opportunity at the annual meeting to pass on all the transactions of the directors. In spite of this notice, no action was taken at the meeting by the stockholders, but several years later they instituted suits against old directors and claimed that they had never been notified of their opportunity to object to the discontinuance of the suits by the corporation itself.

Satisfying claimants.—We shall see when we study the methods applied in reconstruction, that a procedure has been developed to give the company and the persons having claims against it ample time to negotiate with one another to reach a plan involving as large concessions as are practicable on the part of all claimants. Some are in a position to insist upon smaller concessions than others; some even need make no concessions at all, and where such claimants exist, the final plan must provide the pound of flesh they can exact. For example, the expenses of administering a failed concern are very large.[2] The fees of the receiver, court costs, and even the money supplied by people who have made advances to the company to

[2] The expenses of the Southern Railway reorganization of 1894 were estimated at $2,350,000. S Daggett, "Railroad Reorganization," page 182 The fees and expenses paid in the 1929–1930 reorganization of the Cuba Cane Sugar Corporation amounted to $1,071,052 24 For enlightening information on the costs of reorganizations and the various emoluments that flow from the control of a reorganization, see Securities and Exchange Commission Report on the Study and Investigation of the Work, Activities and Functions of Protective and Reorganization Committees, Part I, made pursuant to Sec. 211 of the Securities Exchange Act of 1934.

enable it to carry on its operations while it is in the midst of reconstruction, must be paid on demand. The State will not postpone its claim for taxes. Whatever else is done, one of the objects of the reconstruction is to find the cash to meet these insistent demands.

Providing new management.—Ordinarily, a new management will be necessary to inspire confidence. Sometimes the trouble arises from causes beyond the control of the management; but even in such cases a new group of directors and officers will help to inspire confidence. In many of the older railroad reorganizations a new management had been brought in at the eleventh hour before the collapse. But the trouble had gone too far to be remedied without a receivership and a reorganization. In such cases the management of the railroad after the reorganization had taken place was entrusted to the men who were brought in at the eleventh hour. For example, in the reorganization of 1895 of the Baltimore & Ohio Railroad, Mr. J. K. Cowan was retained as president; he had been made president only a short time before the appointment of the receiver.

Providing fixed and working capital.—If the cause of failure is a lack of fixed and working capital, some plan must be adopted to bring in sufficient funds. As we shall see, in most cases new capital is acquired from people who already have invested in the concern. Even in very small businesses, material men and the makers of machinery are often induced to give further credit to a failed concern where it can be shown that such assistance is indispensable. If these creditors are assured that a new management will run the business efficiently, two reasons may be found to justify further extension of credit: (1) the new investment may save the old investment; (2) the new management may rescue a customer who in the future will be profitable.[3]

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[3] John K Barnes, in *World's Work* (reprinted in *Literary Digest*, April 5, 1924) tells the following story about Andrew W. Mellon, Secretary of the Treasury:

> He was sent by his father to investigate a loan that had been made to a business man who was having difficulty to meet his interest payments Judge Mellon sent Andrew to get all the facts and to form an opinion as to how they could get their money back He told him to stay as long as was necessary (The boy was less than twenty years old) He stayed a week with the man, learned all about his business, and, when he returned, told his father that the way to get their money back was to loan the man $40,000 more The man, he said, was honest and able, and all that the business needed to make it successful was more capital The additional money was supplied, the business prospered, and when that man died he left more than $2,000,000 Some little time later there was some reason to feel apprehension regarding the first loan that Andrew himself had made Judge Mellon remarked to one of the clerks in the bank that he hoped "Andrew's loan" would go bad—"It would be a good lesson to him" But "Andrew's loan" did not go bad, and in a very few years Andrew had taken the entire management of the bank off his father's shoulders and the Judge had practically retired

Reconstruction of financial plan.—Finally, if the company has been trying to support a capitalization too large for its earnings, it must arrange a financial plan that prospective earnings can support. The solution of this problem is to reduce the capitalization. Who shall bear the sacrifices of surrendering securities, and how much of a paring down of capitalization will be necessary, are questions which always arise. Then there is the question of what securities will be given to the people who provide new funds; for new funds in such cases are nearly always necessary. All these questions we shall take up later, in the course of our discussion of reorganization.[4]

Liquidation.—Sometimes the case is hopeless; no curatives will avail; all that can be done is to give the remains decent burial. But this is not as easy as it seems. The object to be attained is to discontinue the business as quickly as possible in order to prevent unnecessary losses, to turn the assets into cash, and to distribute the proceeds as the claimants are entitled to them. The methods of doing this we shall describe later. The old saying, "better fight and run away and live to fight another day" is very appropriate to business. If it becomes apparent that the business is a losing fight, that its conduct will involve continuous losses leading to insolvency, the most valorous thing to do is to wind it up immediately—even before it has become insolvent. A good example of the causes leading to liquidation is furnished by the Carbon Steel Company, which was organized in 1873 and until 1920 was active in the manufacture of high grade steel. It specialized in armor plate, protective deck plate, gun forgings, and other ordnance equipment. The company was one of the heaviest producers of war munitions and equipment in the Pittsburgh district during the World War, and its forgings for rapid fire guns are said to have been the best. With the declaration of peace, and later the success of the disarmament conference at Washington, the market for products of the carbon plant dwindled to the vanishing point. President McKnight said that to change over the machinery equipment to peace uses would have required an outlay of from $7,000,000 to $10,000,000.[5]

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[4] See pages 782 *et seq.*

[5] For outline of method of dissolution, see page 758.

Methods of reconstruction.—The methods of reconstruction—as we have used that word above—may be divided into two classes: (1) negotiated reconstruction; those that do not involve the intervention of a court, and (2) litigated reconstruction; those undertaken with the assistance of a court.

In every case, to be sure, collateral proceedings may be brought in a court of law or equity; but the line of division here suggested is that between proceedings which are based chiefly on negotiation, and those which invoke the sanction of the law to enforce the plan of reconstruction. For example, the reconstruction may consist of the removal of directors and the sale of new securities, in addition to which a legal action may be started against the old directors to recover damages for fraud or neglect. The action in such a case is a collateral matter, and the reconstruction itself would come under the heading of negotiated reconstruction.

We may now subdivide the two main classes as follows:

I. Negotiated reconstruction.

A. Managerial reconstructions, or those involving no sacrifices on the part of owners or claimants.

B. Readjustments without a receiver, or those which do involve some change in the rights of owners, or owners and claimants, to the property, and which are brought about without the intervention of a receiver.

II. Litigated reconstruction.

A. Readjustments with a receiver, or those which involve changes in rights and which cannot properly be negotiated without putting the property into the hands of a receiver.

B. Reorganizations under Chapters X and XI of the Bankruptcy Act.

C. Reorganizations or reconstructions accompanied by foreclosure or sale of the property.

Some legal expedients.—Before we proceed to describe these methods of reconstruction, we must pause to explain some legal expedients which may be used in connection with some of them.

Fundamentally, all persons interested in a business are either owners or creditors.[6] If creditors wish to enforce their

[6] It is hardly necessary in a book of this kind to make the nice distinctions between the relation of creditor and debtor, the relation of trustee and beneficiary, and other relationships, that would be made in an exhaustive legal text. The statement in the text is substantially true.

rights by seizing property, they must establish themselves as creditors in a legal way. Either they must prove that they have a lien of some kind—usually a mortgage—or they must reduce their claim to judgment by bringing an appropriate action.[7] Since a judgment constitutes a lien against the property of the judgment debtor, we may say that creditors ordinarily cannot force action till they have a lien. But when they do have a lien securing a past due debt, they may cause the sheriff or other executive officer to seize and sell the property on which the lien rests. If, for example, *A* obtains a judgment against the *X* company for $10,000, *A* may cause the sheriff to seize enough property to satisfy the claim and to cover all expenses.[8] But if the property of a large business is seized and liens foreclosed, the unity of the business property will be broken up and the business will lose not only the value of the bare property but also the value of the organization as a whole, which depends upon the use of all the property. Moreover, the property sold at a forced sale would not yield nearly as much as it cost, and the fact that the business was being disorganized would frighten customers into believing that the quality of products and service will be lowered.[9] The only way to prevent this train of unfortunate results is to protect the property against haphazard seizures and to undertake a thoroughgoing reconstruction that will yield an

[7] The law provides that in some cases an attachment may be made before a judgment is obtained. This means that when the judgment is obtained, the date of the lien reverts back to the date of the attachment From a legal standpoint the date of the lien is important, for the rule is "priority in time gives priority in equity" The creditor who has the prior lien, even though his priority is measured in seconds, has a better claim to the property for the full amount of the debt secured by the lien, than have subsequent lienors. The State laws are not uniform on the question of the circumstances under which attachments may be made.

[8] It is hardly necessary to add that a judgment is no better than any other lien and that if property on which a prior lien rests is seized to satisfy a judgment, the property must be sold subject to the prior lien, which means that the purchaser at the execution sale would get only an equity in the property, worth the difference between the total value of the property and the amount of the debt secured by the prior lien.

[9] The small amounts available for creditors in bankruptcy cases reflect the results of forced sales In the fourteen years ended June 30, 1933, there were 631,439 bankruptcies in the United States, liabilities of which totaled $10,776,-566,000 The assets realized in all bankruptcies amounted to $1,079,801,000 Of this sum creditors received $814,849,000, or an average of about 7.56 cents per dollar of liabilities See also footnote 27, page 763.

efficient business, one that can inspire and retain the confidence of creditors and customers.

To meet these conditions, three legal expedients are open—assignment for the benefit of creditors, receivership, and bankruptcy.[10]

Assignment for the benefit of creditors.—An old-fashioned legal expedient to prevent individual assaults by creditors is the assignment for the benefit of creditors.[11] If *A*, for example, is beset by clamoring creditors and fears that some will get advantages over others simply because the former are more aggressive, he may assign all his property to some person "for the benefit of creditors"—that is, for the benefit of all creditors. Under such circumstances a vindictive creditor gets no advantage, because there is no property in the hands of a debtor on which a judgment might rest as a lien. The assignee administers and sells the property and distributes the proceeds to the creditors in accordance with their respective rights. Since a receiver protects the property in the same way as does an assignee, and since a receiver moves in accordance with the order of a court and is therefore protected against the chance of making mistakes, the expedient of an assignment for the benefit of creditors is not now frequently used.[12]

Receivership.—When any property is in danger of depreciation through neglect or through disputes as to claims against it, any person interested in it may ask a court of equity to take care of it till it can be liquidated or properly administered without the aid of a court. Equity receiverships are usually resorted to when the debtor, while solvent, does not

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[10] Bankruptcy may be regarded as an expedient to prevent disintegration, though in most instances it is a method of completely winding up an insolvent business Reorganization under Chapters X and XI of the Bankruptcy Act, discussed as a method of reconstruction on pages 766 *et seq*, may also be regarded as a legal expedient

[11] It should be noted that an assignment for the benefit of creditors is considered here merely as a legal expedient for preventing piecemeal dissipation of the property through individual actions by the creditors. Readjustments through creditor management by use of assignments is discussed on page 761

[12] Another reason for the disappearance of this expedient is that an assignment for the benefit of creditors, under the Bankruptcy Act, is a so-called "act of bankruptcy" upon which a petition in bankruptcy may be predicated. Since, then, an assignment will almost inevitably lead to a bankruptcy decree, the better plan is to get into the bankruptcy courts in some more direct way. (See pages 756 *et seq*)

have funds to meet its current obligations.[13] If the equity court does take control of the business, a receiver will be placed in direct charge. In other words, a receiver is an officer of the court holding property for the court and attending to the details of its management. While the receiver holds the property, no person can proceed against it without the consent of the court. Thus a receivership effectually prevents the dissipation of property through haphazard seizures.[14] Moreover, the receiver can retain possession of the property until a plan of reconstruction is worked out, or until the property can be liquidated.[15]

Objects of bankruptcy.—Bankruptcy proceedings constitute a method of reconstruction or liquidation, and since they are conducted according to the formal rules of a statute, we may describe them in full here as a legal expedient.

Originally, bankruptcy was a method by which creditors acting as a group took over an insolvent debtor's property to divide it among themselves in the order of and in proportion to their claims. Later there was introduced the idea of the rehabilitation of the debtor; that is, if the debtor was not guilty of fraud, he was discharged from the proportion of his indebtedness which his assets did not cover. Then, under the present Bankruptcy Act, there was introduced the new idea of protecting the whole class of creditors against aggressive individual creditors. The theory of the present bankruptcy law may be said to be this: if a debtor is declared insolvent—totally insolvent, as that term was defined in the previous chapter—his condition of insolvency must have arisen some time previous to the open declaration of insolvency, and since when insolvency exists all the debtor's property belongs to the creditors, machinery must be provided and is provided by the Bankruptcy Act, to crystallize the relative position of creditors at the time, approximately, when the insolvency began. The Bankruptcy Act fixes this time arbitrarily at four months before the petition in bankruptcy is filed. Practically, then,

[13] Equity receiverships are less frequently used since the amendment of the Bankruptcy Act permitting reorganizations and arrangements without bankruptcy. See page 766 *et seq* A receiver may be appointed for any form of business, including a Massachusetts trust.

[14] Where large corporations having property in various jurisdictions are to be protected by a receiver, it is usual to apply for an ancillary receiver in the court of every jurisdiction in which property is located.

[15] Receiverships sometimes run for long periods The Second Ave R. R. of N. Y. was in the hands of receivers from 1909 till the company was reorganized in 1930.

liens obtained after that time are nullified in the bankruptcy proceedings.

The importance of this provision of the Bankruptcy Act is not appreciated by laymen, and books on corporation finance have generally omitted all mention of the principle. We can well afford to give to it the space that a simple illustration requires.

The following transactions take place on the dates mentioned, *X* being interested in all of them.

January 1, *X* buys from *A* $10,000 of goods on credit.

February 1, *X* gives *B* a mortgage on his factory to secure a loan of $10,000 made the previous year. The mortgage is immediately recorded.

February 15, *X* gives *C* a mortgage on household furniture to secure money borrowed in the previous year.

March 15, *X* gives a chattel mortgage on his machinery to *D*, to whom he owes $10,000 for goods purchased the previous year.

April 1, *X* buys $10,000 worth of goods from *E* and gives a mortgage on his home as security.

May 1, *F* obtains a judgment against *X* for $10,000 for injury to *F* in an automobile accident.

June 5, *A* obtains judgment for $10,000.

July 1, *G*, *H*, and *I* file a petition in bankruptcy against *X* and shortly thereafter *X* is adjudicated a bankrupt.

All liens on *X*'s property obtained within the four months prior to July 1 will be nullified, except those given to secure a debt arising from an increase in *X*'s assets contemporaneously with the creation of the lien. For example, since *E* increased *X*'s assets by delivering goods to *X* when the mortgage was received, *E*'s mortgage will stand. If, however, *E* had sold the goods on credit and the next day had discovered *X*'s position and had demanded and received a mortgage, the lien of the mortgage would be nullified in the bankruptcy proceedings.

F's judgment would be good only as a debt and not as a lien. In other words, *F* would share in the property of *X* with the other general creditors.

D's chattel mortgage would be nullified, since it was given during the four months period. *D* would share in the proceeds with the general creditors.

The mortgages to *B* and *C* would stand as prior claims on the properties mortgaged, since while the mortgages were

given for antecedent debts, they were given and recorded previous to the four months period. The lien of *A*'s judgment would be nullified and *A* would claim only as a general creditor.

To indicate another object of the present beneficent Bankruptcy Act, we may assume that on June 15 *X* sold his machinery to *M*—the machinery on which *D* had a chattel mortgage. We said above that *D*'s chattel mortgage would be nullified because it was given within the four months period. But the Bankruptcy Act provides[16] that a lien of this kind, while nullified as against the interests of the general creditors, will be preserved for their benefit against individuals who might get some advantage by the destruction of the lien.

In this case *M* bought the property with a chattel mortgage on it. He will not be injured if the lien is preserved, for he took the property subject to the lien. On the other hand, as against *D*, the lien is nullified, for otherwise *D* would get an advantage over his fellow creditors. If the machinery is not worth more than $10,000, the entire value goes to the estate of the bankrupt because of *D*'s claim, to be divided among the creditors. *M* would be a creditor—assuming he did not enter into the transaction fraudulently—for the amount of the purchase price, which he would prove as a debt against the bankrupt's estate.

Bankruptcy procedure.—Bankruptcy proceedings may be initiated by the insolvent or by his or its creditors. All persons and corporations except railroad, moneyed (insurance and banking), and municipal corporations, may go into bankruptcy voluntarily. Involuntary proceedings may not be entered against railroad, moneyed, or municipal corporations, or against wage-earners or farmers. In the case of voluntary proceedings, the petition to be declared a bankrupt is filed, and the adjudication usually follows as a matter of course; from then on the proceedings are the same as in involuntary bankruptcy.[17]

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[16] See Bankruptcy Act, Sec 67 A full discussion will be found in the Prentice-Hall Bankruptcy Service

[17] Instead of going into voluntary bankruptcy, concerns usually get some friendly creditors to bring the action Two reasons account for this: in the first place, the debtor gives the appearance of working harmoniously with his creditors, and in the second place, a voluntary bankruptcy precludes a discharge in a future bankruptcy unless at least six years have intervened

In cases of involuntary bankruptcy, the petition is filed by three creditors having claims aggregating $500 or more in excess of the value of securities held by them, or where there are less than twelve creditors, by one creditor with a claim of at least $500. It must be shown that the debtor owes in the aggregate at least $1,000, is totally insolvent, and that a so-called act of bankruptcy was committed within four months of the filing of the petition. These acts of bankruptcy may be enumerated as follows:

1. Transferring or concealing property with intent to defraud creditors
2. Giving preferences to certain creditors
3. Permitting creditors to obtain through legal proceedings any levy, attachment, judgment, or other lien, and not vacating or discharging the same within thirty days.
4. Making an assignment for the benefit of creditors.
5. Permitting, or suffering voluntarily or involuntarily the appointment of a receiver or trustee while insolvent or unable to pay debts
6. Making a statement in writing, admitting insolvency and declaring willingness to be declared a bankrupt.

It is not always necessary, under the statute, that the involuntary bankrupt should have been insolvent at the time the act of bankruptcy was committed or at the time the petition was filed. For example, it is not necessary that the alleged bankrupt should have been insolvent at the time he conveyed or removed property with intent to defraud his creditors. Under the second, third, and fifth acts noted above, however, insolvency at the time of the commission of the act of bankruptcy is essential.

Usually, as soon as the petition is filed, a receiver in bankruptcy is appointed by the bankruptcy court[18] to take the property and to hold it till the trustee in bankruptcy is selected. The latter is an officer elected by the creditors at their first meeting, to hold, and where necessary to recover, the property, to turn it into cash, and to distribute the proceeds according to law. After the proceedings have been begun, the court turns over further control of the administration to a referee in bankruptcy—a minor officer with certain

[18] The Federal district courts are given sole jurisdiction over bankruptcy proceedings, though the proper bankruptcy official may bring and defend collateral actions, such as an action to recover property, in the State courts.

judicial powers. He may make practically all orders necessary to promote the settlement of the bankrupt estate, though he may not discharge the bankrupt. The assets are sold and the proceeds distributed according to law. This means, in a general way, that the expenses of the bankruptcy must first be paid in full, that taxes must then be paid, that secured creditors must next be paid in full out of their security, and that finally the remainder of the estate is to be paid to the general creditors in proportion to their claims.[19] If the bankrupt has not been guilty of fraud, he is discharged from all liability except for certain classes of debts that, with the exception of taxes, are so unusual that they need not be mentioned here. Corporations as well as individuals may be discharged in bankruptcy [20]

Dissolution proceedings.—Sometimes solvent corporations are dissolved, either because the business is shown to be unprofitable and to be leading toward insolvency, or because the owners wish to retire, or because taxes are burdensome, or because some other reason makes the continuation of the business under the corporate form inexpedient. In all such cases the dissolution follows the method prescribed by the appropriate statute of the State where the company was organized. Usually pursuant to a vote of the stockholders, the directors wind up the company, pay the debts, and distribute the remainder of the assets among the stockholders Some formal final step may be required, such as publication of notice of dissolution in a newspaper and filing of appropriate records in the public office in which the certificate of incorporation was originally filed.[21]

Distribution upon dissolution.—The statute under which the dissolution is effected may indicate the order in which claims must be paid. If no order or preference is prescribed,

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[19] Certain wage-earners have prior claims under the terms of the Bankruptcy Act. See, generally, Section 64 of the Act

[20] If one or more, but not all of the general partners of a partnership are adjudicated bankrupt, the partnership property is not administered in bankruptcy except upon consent of the general partner or partners not adjudged bankrupt; but the general partner or partners not adjudicated bankrupt must deliver the partnership business as expeditiously as possible and account for the interest of the general partner or partners adjudged bankrupt.

[21] Sometimes actual liquidation is spread over a considerable period of time. Milliken Bros , Inc., a bridge company, started liquidation in 1913 and in 1918 had only partly finished distributing the proceeds of its assets to the preferred stockholders

the general rules of distribution are followed. These require that debts which are secured by liens must be satisfied out of the security, before the claims of unsecured creditors are paid After payment of secured and unsecured creditors, what remains is divided ratably among the stockholders in proportion to the number of shares held by each. Preferred and common stock share alike, unless some preference in distribution is given to one class of stockholders. The preferences are found usually in the articles of incorporation or in the contract under which the shares are held. Thus, a certificate of incorporation may provide that "upon dissolution, the preferred shall be paid in full at par before any amount shall be paid on account of the common shares." This gives the preferred stock a preference as to assets, but raises this question. have the preferred stockholders a right to share in any surplus beyond the amount required to pay all capital contributions? The courts in this country seem inclined to view the provision that, on dissolution, the preferred shareholders be paid in full before the common, as impliedly taking away from the preferred stockholders the right to participate in surplus assets. After payment of the preferred, the remaining capital would go to the common stockholders. Sometimes a provision is found in the articles of incorporation, to the effect that the cumulative preferred stock shall be entitled to be paid in full the par value of their stock and all unpaid dividends accrued thereon, before any distribution shall be made on the common stock. Such a provision entitles the holders of preferred stock to the par value of their shares plus any dividends which have actually been earned and are unpaid, before anything can be paid to the common shareholders.

Distribution of assets between holders of fully and partially paid stock.—Two more questions arise as to distributions among stockholders upon dissolution. (1) what is the standing of stockholders who have paid a premium on their stock; and (2) what is the standing of stockholders who have only partially paid for their shares? The answer to the first question is that premiums paid above par should be disregarded in ascertaining the shareholder's proportion in distribution. The rule to be applied in answering the second question is that on dissolution, partially paid stock must equalize itself with fully paid stock of the same class before participat-

ing in distributions of depleted capital.[22] This rule may be clarified by the following example: *A* and *B* are sole stockholders of Corporation *X*. *A* has subscribed and paid for $1,000,000 of stock, and *B* has subscribed for $500,000 and has paid $250,000 on his subscription The corporation dissolves, and after payment of all debts, $750,000 is left to be distributed to *A* and *B*. The company has suffered a loss of $500,000, or one-third of the total subscribed capital stock Therefore *B* should lose one-third of $500,000 which he would have paid in, or $166,666⅔; hence he gets only $250,000 less $166,666⅔, or $83,333⅓, leaving $750,000 less $83,333⅓, or $666,666⅔, for *A*. *A* thus loses one-third of what he put in, and *B* loses one-third of what he should have put in.

Reconstruction—investigation as a step.—Having discussed briefly the legal expedients used in connection with reconstruction, we shall now describe the methods of reconstruction outlined on page 751.

Where a company in distress wishes to avoid a liquidation, to preserve all the intangible assets by keeping the working organization, and to renew the vigor of the business with new management or new funds, the first step is to investigate the causes of the trouble and to find the means of obviating them. If the failure is likely to involve sacrifices on the part of the owners or creditors, they will also wish to have a careful study made of the rights of the respective claimants The investigation in such cases may be said to be partly economic and partly legal; the economic part really ascertains the causes of the trouble and recommends the remedy, the legal part lays the foundation for future negotiations covering the sacrifices which owners and creditors must make in achieving the remedy. Oftentimes the trouble is so severe that even before this step can be taken, a public announcement of the difficulties of the concern must be made in order to get into action all the parties in interest.

Managerial reconstruction.—The investigation, if made in due season, may lead to the conclusion that sacrifices need not be made by creditors or owners, that the troubles can be obviated if one or more of the following things be accomplished:

1. Specific faults of present management remedied.

[22] This rule is pronounced in Pennington v. Commonwealth Hotel Construction Co., (1930) Del Ch, 151 Atl 228.

2. A new management installed.
3. New capital obtained.
4. A moratorium declared on debts. By this we mean, not that the debts shall be reduced or interest forgiven, but that maturities shall be postponed. If sacrifices involving any reduction of principal or interest are suggested, the reorganizers will have a more difficult task on their hands than is contemplated by the form of simple reconstruction that is being described here.

If the faults of the managers can be obviated without ousting the managers themselves, so much the better. But if a new management is needed,[23] and if the creditors are asked to withhold pressing claims, some assurance that a satisfactory management will be chosen and kept in power may be exacted. The usual method of accomplishing this end is to turn over the control of the company through a voting trust to people who can be relied upon to maintain a competent management.

If new capital is needed, the old owners, or even the creditors, may be asked to furnish it The best way to do this is to offer them not only satisfactory securities for their new cash, but, by way of bonus, to give some additional advantage in respect to the old securities to all holders who furnish the cash.

Development of creditor committee management.—During the industrial crisis of 1920–1922, many corporations faced insolvency because of the decline in trade and the drop in commodity prices. Banks that had loaned money on inventories at inflated values found that in order to protect their interests they had to either force the delinquent corporations into bankruptcy or find some less costly and more speedy and efficient method of liquidating the debtor's estate. They devised a system of creditor committee management to solve the problem. Under the system, an agreement is entered into between the debtor corporation and the

[23] The following excerpt from *Financial America*, August 6, 1915, indicates the importance of new management:

> The Pullman Motor Car Co., defunct on June 1, 1914, with debts aggregating $160,000, has been so rehabilitated that it is now on a paying basis with all the creditors discharged and is turning out over 500 touring cars and roadsters a month and increasing its productive capacity monthly at the rate of 20 per cent The rehabilitation has been effected by H W Hayden, who was placed in charge as general manager by Benjamin Strauss, who headed the creditors' committee, and has been effected without the introduction of any new capital The present number of employees is twelve times the number which Hayden employed when he began operations.

creditors, whereby control of the embarrassed business is turned over to committees chosen by the latter The agreement generally provides also for the subordination and extension of claims by creditors, and for advances of new funds by banks to provide the company with working capital.[24]

Generally the internal organization of the company is not disturbed, only such changes are made as promote efficiency and effect economies in operation. After a short period of operation under policies formulated by the creditors' committee, those in charge of managing the company determine whether recovery under the new regime is possible, or whether reorganization or liquidation is necessary. If reorganization is undertaken, the creditors' committee supervises the reorganization procedure and acquires representation on the board of directors of the new company.

Creditor committee management with the aid of adjustment bureaus.—Creditor committee management, as an alternative for proceedings in bankruptcy, has received the support of the National Association of Credit Men. The "friendly adjustment" system, which is the name frequently applied to creditor committee management, has been developed in recent years so that settlement of embarrassed enterprises can be handled by a creditors' committee working through its own liquidating agent, an adjustment bureau on the approved list of the National Association of Credit Men. Throughout the country, the member associations of the National Association of Credit Men have created and fostered approved adjustment bureaus.[25] These bureaus are specialists in the field of liquidating insolvent estates and rehabilitating embarrassed debtors. The cases handled are roughly classified as "extension cases" and "assignment cases." In an extension case, the business of the debtor is kept going

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[24] Thus the creditors' committee of the Brockway Motor Truck Corp., appointed in 1930, operated under an agreement which provided that the creditors shall refrain from acting on their debts for a three year period, subject to further extension if approved by a majority in amount of creditors In return, the creditors received 6 per cent non-negotiable notes for the face value of their accounts. The agreement also provided for advances from banks totaling more than $500,000, to furnish working capital that would enable the corporation to continue its operations.

[25] For a detailed description of these bureaus, see "What Price Bankruptcy· A Plea for Friendly Adjustment," by Thomas C Billig, *Cornell Law Quarterly*, June, 1929 See also "In Defense of the Nation's Receivables," published in 1927 by the National Association of Credit Men

through the co-operation of debtor and creditors; in an assignment case, the business is liquidated under an assignment, or deed of trust, taken by a bureau manager as trustee for the creditors.

Advantages and disadvantages of friendly adjustments.—Liquidation through a friendly adjustment is much simpler than through bankruptcy proceedings.[26] The simplicity results in speedier settlements, reduced costs of administration, higher realizations in reducing assets to cash, and curtailment of fraud. One study of results attained through friendly adjustments as compared with those attained through bankruptcy proceedings showed that creditors in the case of friendly adjustments were paid five times the amount of dividends paid in bankruptcy cases, at half the cost.[27]

These advantages do not justify a conclusion that the friendly adjustment method should be substituted in every case for bankruptcy proceedings. Bankruptcy affords a method of legal supervision and furnishes certain protection against fraud that is necessary in the settlement of many insolvent estates. The receiver appointed by a court is in a position to set aside questionable claims of creditors as well as burdensome and unprofitable contracts. The creditors' committee does not have that power. Nor does it have the power to stop legal actions brought against the business by creditors who do not enter into the arrangement The appointment of a receiver immediately halts any action against the company by creditors. On the other hand, the creditors' committee has much more freedom than a receiver and can respond quickly in situations that require immediate action.

The assignment executed by the debtor is an act of bankruptcy, which gives any three creditors, with unsecured claims aggregating $500 or more, the right to file against the debtor a petition for involuntary bankruptcy. The possibility of such action is, of course, a weakness of the friendly adjustment method. Another serious objection to the friendly adjustment is that those who take over the manage-

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[26] The procedure for corporate reorganization under Chapter X of the Bankruptcy Act may prove to be more expedient than the old method of friendly adjustments See page 772

[27] See "What Price Bankruptcy. A Plea for Friendly Adjustment," cited in footnote 25 See also "Friendly Adjustment and Bankruptcy," by Saul Richard Gamer, *Cornell Law Quarterly*, December, 1930

ment of a defunct business subject themselves to damaging criticism in the event of an unsuccessful administration.

Voluntary readjustments.—Frequently the causes of failure cannot be obviated without sacrifice on the part of the owners or creditors. For example, the interest on bonds may be altogether too great to be borne by the company, however faithfully it is managed. This situation is likely to arise where bonds were sold in the first instance at an unreasonably large discount. The bondholders must either entirely forego part of the interest, or commute the interest on part of the bonds for the contingent income of stock or income bonds. For example, in 1912 the earnings of the Hudson & Manhattan Co. were evidently inadequate to meet the demands being made on the company by the mortgage bonds. The holders of these bonds were induced to accept in place of one-half of their holdings an equal amount of income bonds, the interest in arrears on which for a certain number of years was non-cumulative.[28] In 1939, the Baltimore & Ohio R R. succeeded in effecting an $11,000,000 reduction in annual interest charges, and in obtaining an extension of maturities, by a voluntary readjustment plan involving securities valued at $542,812,328

In the reorganization of some Massachusetts textile mills, the stockholders agreed to a reduction of the capital stock by a certain percentage, and authorized the directors to offer the surrendered shares for sale to old shareholders or to bankers. Thus, through the sacrifices of the stockholders the corporations acquired capital without increasing their outstanding stock or adding to their indebtedness.

The main reason why security holders can be persuaded to make such sacrifices usually is that the facts clearly prove that the sacrifice must be made, and that if not made voluntarily, it will be forced and the cost of forcing will simply increase the loss. In other words, a voluntary readjustment saves the cost of receivership.[29]

Readjustments with a receiver.—Often, some plan of reconstruction involving actual sacrifices can be devised and all parties can be made to agree to it, if ample time is avail-

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[28] See C W Gerstenberg, "Materials of Corporation Finance," pages 933–965

[29] The chief difficulty of a voluntary readjustment is that it requires the consent of practically all the creditors The provision in the Bankruptcy Act for corporation reorganization (see p 767) seeks to overcome this obstacle by compelling minority creditors and stockholders to accept the plan of reorganization See also footnote 35, page 771.

able for investigation and persuasion. To guarantee that no rights will be lost during this period, a receiver is appointed.[30] The practical effect is to crystallize the legal and equitable rights against the property as of the day on which the receiver was appointed. To be sure, changes may be made later on account of positions being changed or rights enforced. For example, bondholders may consent to the sale of property covered by their mortgage but released from the lien for the purpose of the sale; or during the receivership it may be decided to foreclose the mortgage on a small part of the property in order to get rid of bothersome security holders who have a subsequent lien on that property. But a receivership generally prevents rights from changing through mere passage of time.[31]

Before or after the receivership proceeding has been instituted, the various classes of security holders and creditors may form committees to protect their respective interests. The discussion of committees in reorganization (page 774) outlines the formation of such committees and the manner in which they proceed to formulate a reorganization plan.

Frequently, when a plan is being prepared no decision is made as to whether it will be enforced through foreclosure (see page 774) or whether the security holders will be asked to

[30] Before the 1934 amendments of the Bankruptcy Act, the most common and generally most effective way of reorganizing a corporation was through equity receivership in the Federal courts, popularly known as "friendly equity suits" Reorganization by such equity receiverships has not been outlawed by Chapter X of the Bankruptcy Act, but the new procedure is now generally followed See page 767 *et seq*

[31] The experience of the American Sumatra Tobacco Co illustrates a voluntary readjustment with a receiver In 1925 the company had practically no indebtedness outstanding except \$2,500,000 five year 7½ per cent gold notes which were about to become due Ample resources were available to assure the ultimate payment of the notes The company was also in a strong current position, but in spite of its apparently favorable situation, the directors were unable to provide for the payment or refunding of the maturing notes, largely because of restrictive provisions in the corporate charter The company was incorporated in Georgia in 1910 The charter, among other restrictive provisions, prevented the giving of any satisfactory security for a refunding loan without the unanimous consent of the preferred stockholders After unsuccessful attempts to raise sufficient money to meet or to refund the maturing notes, the directors consented to an equity receivership as essential in order to protect the rights of all interests Within a few months after the appointment of the receiver the notes were paid off The company was reorganized under a charter that removed the cumbersome restrictions and a financial plan was adopted that avoided the imposition of any funded debt on which there would be heavy fixed charges.

accept it voluntarily. Much will depend on the sacrifices that the security holders are asked to make. Moreover, other questions may affect the plan of reconstruction and the method to be selected for enforcing it. For example, who are sponsoring the plan of reconstruction? Is the business cycle improving in a way to give promise that if the sacrifices are made the concern will be successful?[32] When it comes to the final offer, the security holders may refuse the plan. They then are open to the danger of a worse and more drastic plan necessitated by the costs of the legal proceedings incident to foreclosure.[34]

Corporate reorganization under Chapter X of the Bankruptcy Act.—Reorganization of industrial corporations in the bankruptcy courts, without the stigma of bankruptcy, was first introduced by the addition of Sec. 77B to the Bankruptcy Act in 1934. This section furnished a simpler, less troublesome and less expensive reorganization procedure than that previously available. It eliminated certain procedures which had impeded administration and caused undue expense in equity receiverships, it rendered unnecessary the fiction of a judicial sale as a means of effecting a reorganization; and it gave the courts power to scrutinize the compensation and activities of the persons who participated in reorganization proceedings. As a result of the legislation, hundreds of corporations were rehabilitated under Sec. 77B. Four years

[32] See the plan of reorganization of the Baltimore & Ohio Railroad in 1899, S Daggett, "Railroad Reorganization," pages 1–30; and see for the agreement of reorganization, C. W Gerstenberg, "Materials of Corporation Finance," pages 966–1000

[34] Dewing points out in his "Financial Policy of Corporations," that the security holders of the Missouri Pacific rejected a voluntary plan of reorganization and later were forced to accept the identical plan at a much greater cost See page 1111

Unfortunately, where a reconstruction is advisable but where it cannot be enforced through foreclosure proceedings, the chances of a voluntary readjustment are not very good For example, in 1916 a firm of bankers proposed a readjustment of the American Hide and Leather Co , the preferred stock of which had claims for arrearages of dividends amounting to about 100 per cent Shortly thereafter the management announced that all plans "were off," since it was evident that the common stockholders could not be persuaded to listen to the plan. It was said that nothing would be done till the bonds of the company matured several years later, and the committee of preferred stockholders asserted that such a procedure would help them, for a foreclosure would then undoubtedly wipe out the common stock interest entirely. However, the company was able to pay off its bonds at maturity. The capital was not readjusted until 1925 See page 736, footnote 12

of experience, however, revealed certain defects which Congress sought to overcome in the 1938 revision of the Bankruptcy Act by the so-called Chandler Act. Sec. 77B was changed and superseded by Chapter X of the revised Bankruptcy Act.[34] This chapter also applies to the reorganization of public utility corporations and intrastate railroads—that is, all railroads not eligible for reorganization under Sec. 77 of the Bankruptcy Act.

Procedure for reorganization under Chapter X.—A corporation may initiate the proceeding under Chapter X, in which case it is known as a voluntary proceeding. An involuntary proceeding may be instituted by three or more creditors who have claims against the corporation or its property which amount in the aggregate to $5,000 or more. A trustee under a mortgage, deed of trust, or indenture under which there are securities outstanding may also file an involuntary petition without the co-operation of any of the corporation's creditors, if the securities outstanding under the indenture are liquidated as to amount and not contingent as to liability. No one may file a petition if one has already been filed by or against the corporation.

The petition, whether voluntary or involuntary, must contain certain matters prescribed by the statute and must state why adequate relief cannot be obtained under Chapter XI of the Bankruptcy Act, dealing with "Arrangements," explained at page 772. The corporation may file an answer controverting the facts alleged in an involuntary petition. Individual creditors, indenture trustees, and stockholders, regardless of the size of their claims or holdings, may answer a voluntary or involuntary petition, controverting the allegations in the petition. If the petition complies with the law, and has been filed in good faith, the judge must approve it. If the petition is contested, the judge must be satisfied that the material allegations in the petition are proved. The statute contains certain provisions to aid the judge in determining when a petition is filed in good faith.

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[34] For a summary of the philosophy of the corporate reorganization provisions of the Chandler Act, see Alfred N. Heuston, "Corporate Reorganization under the Chandler Act," 38 *Columbia Law Review* 1109. See also John Gerdes, "Corporate Reorganizations: Changes Effected by Chapter X of the Bankruptcy Act," 52 *Harvard Law Review* 1. For complete information on the Bankruptcy Act, see Prentice-Hall Bankruptcy Service.

Upon the approval of a petition, the judge must appoint one or more disinterested trustees in every case in which the debtor's liquidated and noncontingent indebtedness amounts to $250,000 or more. In cases where the indebtedness is less than $250,000, the judge may appoint one or more trustees, or he may continue the debtor in possession He may also appoint a director, officer, or employee of the debtor as an additional trustee for the purpose of operating the business and managing the property of the corporation

If the debtor remains in possession of the property, it must file certain schedules which supply essential information with regard to the location, assets, and liabilities of the estate, comparable to the information which the trustee, where appointed, must file The debtor's schedules also supply the names and addresses of creditors and stockholders. The trustee must make an investigation, if the judge directs him to, of the acts, conduct, property, liabilities, and financial condition of the corporation, the operation of its business, and the desirability of its continuance, as well as of other relevant matters. Whether or not investigation is ordered, any facts ascertained by the trustee pertaining to fraud, misconduct, mismanagement, and irregularities and to any cause of action available to the estate must be reported to the judge. A statement of the report of any investigation is sent to creditors, stockholders, indenture trustees, and other persons, as the judge may designate.

Procedure relating to plans.—Within a period of time fixed by the judge, the independent trustee must prepare and file a plan, or must report the reasons why a plan cannot be effected. He is aided in the preparation of the plan by suggestions and proposals submitted by the creditors and stockholders. In fact, the trustee is required to give notice to the creditors and stockholders that they may submit to him suggestions for the formulation of a plan, or proposals in the form of plans. A hearing is held on the trustee's plan at which objections may be considered or new proposals submitted by any creditor, stockholders, or the corporation. Any plan which the judge regards as worthy of consideration must be submitted to the Securities and Exchange Commission where the indebtedness exceeds $3,000,000; in other cases, submission of the plan to the Commission is optional with the judge. After the Commission has rendered its

advisory report, the judge may approve any plan which in his opinion complies with the Act and is fair, equitable, and feasible. More than one plan may be approved and submitted to the creditors and stockholders, but no solicitation of acceptances of any plan may be made unless the plan has been approved by the judge. A time is fixed within which the creditors and stockholders affected by a plan may accept it. The acceptance by two-thirds in amount of each class of creditors whose claims have been allowed, and, if the corporation is not insolvent, by a majority of the stockholders of each class affected, is necessary before any plan can be confirmed and carried into effect. After the requisite acceptances have been filed, the plan is confirmed at a hearing. It is carried out subject to the court's supervision and control, and is binding upon dissenting creditors and stockholders.

Mandatory provisions of a plan.—The Act prescribes certain provisions that must be included in every plan of reorganization, and indicates others which may be included. The following are the mandatory provisions:

1. Alteration or modification of the rights of creditors generally or of some class of them. Provisions may be included altering or modifying the rights of stockholders, or some class of them

2. Payment of all costs and expenses of administration and other allowances approved or made by the judge.

3. List of claims, if any, which are to be paid in cash in full.

4. List of claims or stock not to be affected by the plan and provisions, if any, with respect to them.

5. Treatment of any class of creditors affected by the plan where two-thirds of such class fail to accept the plan

6. Protection of the interests of non-assenting classes of stockholders, if the debtor is not insolvent.

7. Adequate means for the execution of the plan through transfer of the property to a successor corporation, merger, or consolidation with other corporations, or any one or more of a number of other general methods stated in the Act.

8. Provisions with respect to the manner of selection of officers, directors, and voting trustees which are equitable and compatible with the interests of creditors and stockholders and consistent with public policy.

9. Provisions in the charter of the corporation or of any successor corporation prohibiting the issuance of non-voting

stock, and insuring the fair and equitable distribution of voting power among the various classes of stock. In the case of preferred stock, adequate provision must be made for the election of directors representing such preferred stock in event of default in dividends.

10. Fair provisions with respect to the terms, position, rights, and privileges of the several classes of securities.

11. Provisions in the charter requiring the issuance of financial statements annually to security holders, if the indebtedness is at least $250,000.

12. Retention and enforcement of claims belonging to the estate which are not settled or adjusted as part of the plan.

Exemption from registration of securities.—Securities issued pursuant to a plan of reorganization under Chapter X are exempt from registration under the Securities Act of 1933 and from the requirements of the Act as to contents and use of prospectuses, if they are issued to security holders or creditors of the corporation in whole or in part in exchange for their old securities or claims New issues sold by the reorganized company for cash are required to be registered just as any other new issue of securities.

Reorganization of public utility corporations under the Bankruptcy Act.—As previously indicated, Chapter X of the Bankruptcy Act, discussed in the preceding paragraphs, provides the reorganization procedure for public utility corporations and for intra-state railroads, as well as for industrial corporations. The preceding explanation therefore applies to these classes of corporations, with the following slight modifications. The plan of reorganization for a public utility corporation may not be approved before it has been submitted to any Commission having regulatory jurisdiction over such corporation, and the judge, at a hearing, has considered the objections and amendments, if any, offered by such Commissions In the case of wholly intra-state public utilities, no plan can be approved until the State Commission having regulatory jurisdiction over the debtor has approved the plan. The jurisdiction of the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935 is in no way affected by the provisions for reorganization under Chapter X of the Bankruptcy Act.

Reorganization of railroads under the Bankruptcy Act.—In 1933 the Bankruptcy Act was amended by the addition of

Section 77 to provide a simple and effective method of reorganizing railroads in interstate commerce. Prior to 1933, a railroad desiring to reorganize had to do so either by voluntary agreement with its creditors and security holders or through equity receivership proceedings and foreclosure or other judicial sale. These old processes of rehabilitation were not only expensive and cumbersome, but in many instances were rendered ineffective by the dissenters [35]

The procedure for reorganization of railroads under Section 77, as amended, is similar to that provided for corporations reorganizing under Chapter X (see pages 767 *et seq.*) It varies in some respects, however, principally because of the regulation of railroads by the Interstate Commerce Commission. Thus, a copy of the petition, whether voluntary or involuntary, must be filed with the Interstate Commerce Commission. The appointment of a trustee or trustees must be ratified by the Commission. Before the acceptance of any plan, the Commission must hold a public hearing and render a report recommending the plan. The Commission, furthermore, has the power to value the property of the railroad, when necessary. It also is given the task of submitting to the creditors and stockholders any plan approved by the court.

The following represent other variations from the reorganization procedure explained in the preceding pages:

1. Creditors having claims aggregating 5 per cent of all of the indebtedness of the railroad may petition for a reorganization of the corporation.

2. No provision is made for appointment of a receiver, or for permitting the property to remain in the possession of the corporation. Rather, the judge must appoint one or more trustees to hold title to the railroad's estate.

3. The railroad must file a plan of reorganization with the court and with the Interstate Commerce Commission within

[35] Although Sec 77 was designed to expedite railroad reorganizations, proceedings thereunder have been slow, principally because of the lack of earning power and the uncertainty of future earnings of the roads Experience with Sec 77 demonstrated the necessity for legislation to enable sound railroads to effect a plan of postponement or modification of maturing obligations with the consent of less than all of the creditors. To meet this need, the Railroad Adjustments Act was passed in 1939, by adding Chapter XV to the Bankruptcy Act Before enactment of the law, such adjustments could be made through voluntary agreements or equity receiverships only if there were no objecting creditors. The Act is a temporary measure, however, and will expire July 31, 1940.

six months after approval of the petition. The court may extend the date, from time to time, for periods not exceeding six months. Plans may also be filed by trustees, or by creditors or stockholders constituting 10 per cent or more in amount of any class, or by any interested party with the consent of the Commission

4. Before the judge may confirm a plan, it must be accepted by creditors of each class holding two-thirds in amount of the total claims of such class and by two-thirds of each class of stockholder

5. Even if the plan has not been accepted by creditors and stockholders, the judge may confirm the plan if it provides fair and equitable treatment to those who reject it.

Arrangements under the Bankruptcy Act.—Corporations whose only problem is an adjustment of unsecured debts may be reorganized under Chapter XI of the Bankruptcy Act as amended in 1938 by the Chandler Act. This section of the Act supplants the provisions of the old Bankruptcy Act dealing with compositions and extension of time for payment of debts.

Procedure under Chapter XI.—The corporation in financial difficulties files a petition with the proper court, stating that it is insolvent or unable to pay its debts as they mature, and setting forth the provisions of the arrangement proposed by it. The court may appoint a receiver of the property, if necessary, or if a trustee in bankruptcy has previously been appointed, the trustee may continue in possession. If no receiver or trustee is appointed, the corporation continues in possession of its property. The court is required promptly to call a meeting of creditors upon at least ten days' notice by mail to the corporation, the creditors, and other interested parties. This notice contains a copy of the proposed arrangement, as well as a summary of the balance sheet of the corporation. At the meeting, the judge or referee receives proofs of claims and allows or disallows them; he also examines the debtor, hears witnesses, and receives the acceptances of the proposed arrangement by the creditors. These acceptances may be obtained by the corporation before or after the filing of a petition under Chapter XI.

If the arrangement is not accepted at the first meeting by all the creditors affected, it may be confirmed after acceptance in writing by a majority in number of all creditors,

representing a majority in amount, or, if the creditors are divided into classes, by a majority in number and amount of all creditors of each class affected by the arrangement After acceptance of the arrangement, the court appoints the receiver or trustee, or some other person, to receive and distribute, subject to the control of the court, the moneys and consideration, if any, to be deposited by the corporation It also fixes a time within which the corporation must deposit the consideration to be distributed to the creditors, as well as the money necessary to pay all debts which have priority, and all costs and expenses incurred in connection with the proceedings

The court is given certain powers through the exercise of which relief is afforded to the corporation. For example, it may permit the rejection of executory contracts, authorize the receivers or trustees, or the corporation, if it is in possession of the property, to lease or sell any property of the corporation upon terms approved by the court; enjoin or stay the commencement or continuation of suits, including suits to enforce liens where notice has been given and cause shown, and do other enumerated acts.

Upon confirmation of the arrangement, the debtor is discharged from all unsecured debts provided for by the arrangement, except undischargeable debts. These include taxes and wages earned by employees within three months from the commencement of the proceedings. If an arrangement is not confirmed, the court may dismiss the proceedings and direct that the bankruptcy be proceeded with pursuant to the provisions of the Bankruptcy Act.

The arrangement provisions.—An arrangement, within the meaning of Chapter XI, *must* include provisions modifying or altering rights of unsecured creditors generally or of some class of them upon any terms or for any consideration. It *may* include provisions for the following:

1. Treatment of unsecured debts on a parity one with the other, or for the division of such debts into classes and the treatment thereof in different ways or upon different terms;
2. Rejection of any executory contract;
3. Specific undertakings of the debtor during any period of extension provided for by the arrangement, including provisions for payments on account,
4. Termination, under specified conditions, of any period of extension provided by the arrangement;

5. Continuation of the debtor's business with or without supervision or control by a receiver or by a committee of creditors or otherwise;

6. Payment of debts incurred after the filing of the petition and during the pendency of the arrangement, in priority over the debts affected by such arrangement,

7. Retention of jurisdiction by the court until provisions of the arrangement, after its confirmation, have been performed; and

8. Any other appropriate provisions not inconsistent with Chapter XI.

Reorganization forced through foreclosure.—Prior to the amendment of the Bankruptcy Act providing for corporate reorganization under that Act (see pages 766 *et seq*), a reorganization was often effected by obtaining the support of a majority of the interested parties, through the organization of protective and reorganization committees, or otherwise, and forcing a plan of reorganization through foreclosure. The new method of reorganization under the Bankruptcy Act is eliminating this practice of reorganization through foreclosure. However, since the old method of reorganization is not outlawed by Chapter X of the Bankruptcy Act, we shall describe it in some detail. The student should at any rate be familiar with it, since it represents the principal method used in reorganizing large corporations before 1934.

Committees in reorganization.—In most reorganizations of large corporations, the various classes of security holders and creditors form committees to protect their respective interests. While committees are formed in the reorganization of corporations under Chapter X of the Bankruptcy Act[36] in much the same way as described below, the following paragraphs apply particularly to committees for the reorganization of corporations in equity receiverships or without court supervision.

[36] Chapter X does not contain any provisions regulating protective committees and other representatives of security holders. It does, however, provide that no committees, indenture trustee, or agent purporting to represent creditors or stockholders shall be heard or allowed to intervene until they have complied with all laws applicable to such persons Chapter X also requires a statement under oath from every person or committee representing more than twelve creditors or stockholders and by every indenture trustee appearing in the proceeding, explaining the details of the representation Furthermore, the judge is given power to examine and disregard the provisions of trust indentures, deposit agreements, and other authorizations

As soon as real danger is imminent, committees are organized to represent every class of security holder that has any rights dissimilar to those of other classes. In an industrial company, one committee may represent the bonds, another the preferred stock, another the common stock, and a fourth the general creditors. While such a procedure is expensive, it has the decided advantage of avoiding any unfavorable effects of conflicting interests. The practice of having a single committee represent two or three classes of securities was in vogue for a short period of time, but was generally abandoned.

The holders of the important mortgage bonds are usually governed by a clause in their mortgage which provides that a certain majority can bind the rest. The committee managers[37] therefore seek to get enough bonds deposited under the terms of the depositary agreement to achieve such control. The deposit agreement generally provides that bonds cannot be withdrawn until a reorganization plan has been submitted. It also usually provides that if bondholders do not file dissent within a specified time after the reorganization plan has been submitted, they will be held to have assented. Usually, in the case of large companies, the certificates of deposit given in place of the bonds deposited with the committee are transferable by delivery or by indorsement and are listed on the exchanges.

After these various committees have been organized, they then form a reorganization committee[38] which works out a plan of reorganization If the plan receives the approval of the security holders' committees, it will either be put through voluntarily by acceptance by the security holders or it will be forced through by a foreclosure, as explained below.

[37] Members of the committee will include representatives of holders of large blocks of bonds—insurance companies and large estates—who will be assisted by a secretary, probably a junior member of the managers' firm, who attends to all the details, and also by counsel

[38] The investigation of the work, activities, personnel, and functions of protective and reorganization committees by the Securities and Exchange Commission, pursuant to Sec. 211 of the Securities and Exchange Act of 1934, disclosed "that reorganizations have generally been in the control of inside groups—that is, the management, the bankers, or the two together—and that rarely have groups not affiliated with the management or houses of issue wrested control from the insiders The stakes of reorganization, the fight for control of the reorganization, and the strategy and techniques of protective and reorganization committees, representing both inside and outside groups, are described in great detail in the Commission's report on the investigation

Effect of foreclosure.—We may assume that a plan of reorganization has been prepared and agreed upon by the reorganization committee and that it is submitted to the bondholders' committees and to the other protective committees. We may assume that these committees, or at least the committees representing the mortgage bonds, have assented There remain, however, a number of bondholders and stockholders who have not deposited their securities with any committee, and also a minority group within the committees How can the reorganization plan be forced through in spite of the expressed objection and the silence of the disgruntled and negligent security holders? In the first place, the plan of reorganization is submitted to a court, and if any definite rights are invaded or any fraud committed, the court will not approve the plan. But if the plan is approved, the court will enter a decree of foreclosure and order the property sold Upset prices for the property to be sold may be fixed by the court as a further means of controlling the purchase of the property by the committee. To understand the full effect of such a sale, the reader will do well to read the important parts of a notice of sale, given as follows.

. COMPANY, INC
NOTICE OF SALE

NOTICE IS HEREBY GIVEN, pursuant to an Amended Foreclosure Decree, made , 19 . . that I, . . , appointed Special Master in and by the aforesaid Decree, will sell at public auction to the highest bidder or bidders, upon the premises at the main office building of the defendant, . Company, Inc, opposite the passenger station of the New York Central Railroad Company, in the Village of Hastings-on-Hudson, County of Westchester and State of New York, at 1.30 o'clock P. M., United States Eastern Standard Time, on the . day of , 19 , the properties in said Decree described and thereby ordered to be sold, to wit:

I. All properties of every kind, character and description covered by the lien of the First Mortgage of the defendant, dated April 1, 19 , and

II All other properties of every kind, character and description of the defendant and of its Receiver.

A brief general description of the properties to be sold at said sale is as follows·

I Properties subject to lien of First Mortgage·

(Here follow descriptions of the properties)

Said sale will be made in the manner provided by said Decree and subject to the terms and provisions thereof, and all bids for any property

offered will be received and noted only on condition that said property may subsequently be offered, knocked down and sold, as in said Decree provided

There will first be offered for sale separately and as one parcel, all of the properties embraced within Parcel Three [Here follows statement of parcels to be offered] If the highest bid received and noted for said properties, when so offered for sale as an entirety, shall equal or exceed the aggregate of the highest bids therefor when offered for sale in parcels, then all of said properties shall be stricken off and sold as an entirety to the highest bidder therefor If, however, the highest bid received and noted for said properties as an entirety shall be less than the aggregate of the highest bids therefor when offered in parcels, then the parcels offered for sale shall be stricken off and sold to the highest bidders for said respective parcels.

As more fully provided by said Decree

I Said sale will be made without valuation, appraisement, redemption or extension.

II In case of adjournment or postponement of the sale, the Special Master, without further notice or advertisement, may proceed with the sale on any day to which the same may have been adjourned

III. The Trustee, or any holder of the bonds, or any creditor or any stockholder of the Company, or any party to this Consolidated Cause or to any constituent cause, may bid at the sale, and if a successful bidder, may purchase in his, its or their right

UPSET PRICES

IV The Special Master will not accept any bid

For Parcel One, less than $300,000 00

For Parcel Two, less than $600,000 00

For all properties covered by the Lien of the First Mortgage, being Parcels One and Two together, less than $900,900 00

For Parcel Three, less than $2,100,000.00

For all properties as an entirety, being Parcels One, Two and Three together, less than $3,000,000 00.

V. The Special Master will receive no bid from anyone offering to bid who shall not, prior to any offering by the Special Master under said Decree, deposit with the Special Master and deliver to him as a pledge that he will make good his bid in the event of its acceptance, in cash or certified check of some National Bank or Trust Company in the City of New York, acceptable to the Special Master, and made and indorsed to his order, or in the First Mortgage Six Per cent Ten Year Sinking Fund Gold Bonds (hereafter called "bonds") of the defendant (such bonds to be in bearer form, and, if coupon bonds, accompanied by the coupon of October 1, 19 , and all subsequent coupons) or in respect of Parcel Three in claims against the said defendant which have been heretofore presented to and filed with the Receiver in this Consolidated Cause or in the con-

stituent causes or either of them, and admitted or allowed by the Receiver, accompanied by proper and appropriate assignments thereof to the Special Master, in respect of Parcels One and Two, partly in cash and/or certified check, and/or partly in such bonds but in the same relative proportions, and in respect of Parcel Three partly in cash, and/or certified check and/or partly in bonds and/or partly in such claims accompanied by such assignments, but in the same relative proportions.

1 In case of Parcel One, when offered separately, the sum of $30,000 in cash or such certified check, or $60,000 face amount of such bonds;

2 In case of Parcel Two, when offered separately, the sum of $60,000 in cash or such certified check, or $120,000 face amount of such bonds,

3 In case of Parcels One and Two, when offered together, the sum of $90,000 in cash or such certified check, or $180,000 face amount of such bonds,

4 In case of Parcel Three, when offered separately, the sum of $210,000 in cash or such certified check, or $420,000 face amount of such bonds or an equivalent face amount of such claims accompanied by such assignments,

5 In case of Parcels One, Two and Three, when offered together, $300,000 in cash or such certified check, or $600,000 face amount of such bonds or an amount in cash and/or such certified check and/or such bonds at least sufficient to qualify the bidder to bid for Parcels One and Two, and the balance in the requisite face amount of such claims.

A deposit made by any bidder for a separate parcel may, so far as applicable, be applied on account of the required deposit, in order to qualify him to bid for the same property when offered for sale with any property when offered as an entirety.

Any deposit received from an unsuccessful bidder will be returned to him when the property shall be struck down The deposit received from the successful bidder or bidders will be applied on account of the purchase price of the property purchased by such bidder or bidders

If any sale shall not be confirmed, the deposit made by the accepted bidder at such sale will be forthwith returned to such bidder.

The deposit made by any successful bidder shall, in accordance with the provisions of said Decree, be forfeited in the event of his failure to comply with any order of the court within ten days after the entry thereof, requiring payment of or on account of the balance of the purchase price.

The purchaser (which term includes purchasers and includes also the successors and assigns of any purchaser) to the extent permitted by said Decree and otherwise in accordance with the provisions thereof, may turn over to the Special Master on account of the purchase price, at their distributive value, bonds, coupons and claims entitled to be paid out of the proceeds of sale

In lieu of bonds, coupons or claims tendered for deposit to qualify a bidder or tendered by a purchaser on account of the purchase price, the Special Master will accept the certificate of any national bank or trust company in the City of New York, N. Y., acceptable to the Special Master, that it holds, subject to the order of the Special Master, bonds or notes of the required character in bearer form and, if in coupon form, accompanied by the specified coupons.

The term, "in bearer form," as used herein with reference to securities, includes both securities expressed to be payable to bearer and securities accompanied by an assignment in blank duly executed

VI. Any successful bidder may assign, transfer and set over his bid, in whole or in part, and all or any part of his rights and interests under the said Decree

Any purchaser, his successors and assigns, may enter his appearance in this consolidated cause and in the constituent causes, and exercise the rights thereafter conferred by said Decree Any purchaser, his successors or assigns, shall have the right for a period of two months after conveyance of the property purchased by him, to elect whether or not to assume or adopt any lease or contract made by the Company, as part of the property embraced in said conveyance, and may elect not to take or accept any part of the property purchased by giving written notice of his election to the Special Master at any time prior to the execution and delivery of the deed or other instruments of conveyance from the Special Master, but no such election shall diminish or affect the purchase price to be paid by such purchaser

Neither any purchaser nor the successors or assigns of any purchaser shall be required to see to the application of any purchase money.

VII The purchaser or purchasers of Parcel One, Parcel Two or Parcel Three, their successor or successors and assigns, as part of the purchase price, and in addition to the accepted bid of such purchaser, shall pay, satisfy, assume and discharge

(A) Any unpaid compensation which has been or shall be allowed to the Special Master heretofore appointed in said Consolidated Cause, and any unpaid compensation that has been or shall be allowed to the Receiver in said Cause or in either of the constituent causes and his solicitors, and also any unpaid indebtedness and liabilities and all contracts and guarantees of the Receiver made or incurred in said Cause, or in either of the constituent causes, and any other administrative expenses incurred or to be incurred in the management or operation of the properties purchased and otherwise in the discharge of his duties as such Receiver between . . . , 19 , the date of his appointment, and the date of the delivery by the Receiver of possession of the properties sold,

(B) Any unpaid claims of creditors of the Company which have been or shall be admitted by the parties in interest or adjudged by said Court to be prior in lien or superior in equity to the mortgage,

(C) All just and legal indebtedness of the Company payment of which was authorized by the order of said Court appointing the Receiver in said Cause or in either constituent cause, and which shall not at the time of delivery by the Receiver of possession of the property sold have been paid or satisfied.

to the extent that they have not been paid or shall not have been paid out of moneys in the possession of the Receiver.

. . . .

Dated ...., 19 ..

Special Master.

From this notice of sale it will be observed that the bonds and debts of the concern may be used in part payment of the purchase price.[39] At the time of the sale, therefore, if the reorganization committee has control of a large number of claims, it is in much better position than any other group, because for the purpose of buying the properties the claims are worth par. For example, if the reorganization committee controls $5,000,000 of claims and outside groups $2,000,000 of claims, the latter will have to supply $3,000,000 in cash before they are in as good condition as the former to bid in the property. Stockholders, of course, have no legal standing at all, for their interest is wiped out by the foreclosure decree and sale.[40]

The reorganization plan usually calls for the formation of a new company, with a name somewhat similar to the old name, to which the property can be transferred at the time of the sale For example, in 1894 the Central of Georgia *Railroad* was reorganized into the Central of Georgia *Railway*.[41] The proper representative of the reorganization committee bids in the property at the sale. The purchased property is held by the committee for the benefit of the depositors, until it is transferred to the new corporation in exchange for new securities to be distributed to the holders of deposit certificates according to the terms of the reorganization plan.

How a company is kept in operation during receivership.—One of the important duties of the receiver is to keep the company in operation, in order that customers may not be lost and in order that the personnel may be kept together. Money beyond the cash income of the concern may be necessary for this purpose. Not only wages, but supplies ordered during receivership and those ordered a reasonably short time before receivership—say six months—must be paid in cash. In railroad practice it is necessary even to pay interest on important mortgage bonds.

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[39] A similar provision is usually contained in the mortgage itself See C W Gerstenberg, "Materials of Corporation Finance," page 231

[40] It may be asked, why then are the stockholders taken into the new company, why do they figure in the reorganization at all? Two reasons are sufficient to answer this first, they are the logical persons from whom cash may be obtained, and to give them some interest in the new concern conditioned on their paying an assessment is good policy, in the second place, if they can be induced to consent to all the proceedings, expensive litigation over irregularity in details—and the details are almost infinite—may be avoided.

[41] For other examples, see S Daggett, "Railroad Reorganization"

The receiver depends, of course, on the ordinary receipts of the business, and he may proceed to sell unnecessary property. But he may go beyond this and borrow money on the order of the court The people who furnish the money get receiver's certificates. These are negotiable and the holders have such priority of claims as is indicated in the order authorizing the issue Usually the claim is just prior to that of the mortgage securing the bonds whose holders asked for the receiver, though the court, having general equity powers, may order the priority in any way it deems necessary to protect all interests.

CHAPTER XXXV

RECONSTRUCTION OF CORPORATIONS (CONTINUED)

Sacrifices made in typical readjustment or reorganization. In most readjustments and reorganizations, changes are made in internal organization, but the most important changes are made in the claims against the property. Every claim against the property may be analyzed as follows:

1. Amount of principal.
2. Legal precedence of principal in claim on assets.
3. Amount of interest or dividends.
4. Precedence of interest or dividends in claim on income
5. Property of company against which principal and income have claim.

The chief claimants for whom cash must be raised, aside from claims for taxes and costs, may be classified on the basis of the legal positions they occupy, as follows. holders of receiver's certificates,[1] the senior mortgage bondholders, junior bondholders, divisional or subsidiary company bondholders, unsecured creditors with a preference, unsecured creditors without preference, preferred stockholders, and common stockholders.

The net result to the company of all the sacrifices the security holders are called upon to make must be the provision of an adequate amount of cash for the needs of the reorganized company, the elimination of the floating debts, a reduction of the fixed charges to an amount that can quite certainly be met year in and year out, and the creation of a stock issue not so large but that the holders of it may expect to derive some income through it from the earnings left after the payment of the fixed charges. In general, the financial problems of those undertaking the reorganization are to submit a plan with a reduced capitalization of which as small a part as possible shall be bonds, and to provide sufficient cash for working capital and other necessary pur-

[1] See statement in previous chapter about position of holders of receiver's certificates, page 781.

poses to permit continuation of the business. To accomplish these general purposes the several classes of security holders may be asked to make one or more of the following sacrifices.

1. Payment of assessment.

2. Reduction in amount of principal; a preferred stockholder, for example, may be asked to take 80 per cent as much stock in the reorganized company as he had in the failed company.

3. Postponement of precedence of principal; a holder of a junior mortgage bond, for example, may be required to take preferred stock in place of his bonds. Sometimes a bondholder will be asked to accept bonds for part of his bonds in the old company and to take the rest in stock.

4. Reduction in rate of income—dividends or interest.

5. Postponement of precedence of income.

Just what sacrifice each class of claimant will make will depend on their legal rights, the nature of the property against which they may have specific claims, and on certain psychological factors that enter into the negotiations of the reorganization committee. For each particular class the question must always be: what would it lose if the company simply sold out and distributed the cash proceeds, and what would it gain if the proposed reorganization plan were carried out?

Treatment of stockholders.—The investigations made by the Securities and Exchange Commission pursuant to Sec. 211 of the Securities Exchange Act of 1934[2] revealed that stockholders and other investors frequently suffered irreparable damage from the selfish motives of those in control of the reorganization. The future, however, appears brighter for investors. As previously indicated, in reorganizations under Chapter X of the Bankruptcy Act, all classes of security holders must be given consideration. The result is a tendency toward better treatment of stockholders. An effort is usually made to give the old stockholders some interest in the reorganized company, if it is only a warrant to purchase some of the corporation's new securities in the future, or a right to subscribe to stock of the new company. For example, in the reorganization of the Colorado Fuel & Iron Co. under Sec. 77B of the Bankruptcy Act, old preferred stockholders received warrants to purchase three new common shares at $35 per share before Feb. 1, 1950, for each share held, and old

[2] See footnote 38, page 775.

common stockholders received warrants entitling them to purchase three-fourths of a share of a new common stock at $35 per share up to the time indicated In certain instances, however, it may still be necessary to wipe out the stockholders' interests, as it was in the reorganization of the National Radiator Corp. under Chapter X of the Bankruptcy Act [3] See page 794.

Prior to the enactment of Sec. 77B of the Bankruptcy Act, plans of reorganization generally included an assessment upon the common and preferred stockholders to provide needed cash. If the stockholders paid the required cash, they were given stock in the new company in proportion to their holdings of old stock—usually less than dollar for dollar. If they failed to pay the assessment, they lost their equity. The assessment method of providing cash for the rehabilitated company is still resorted to in reorganization, but less frequently than formerly. The amount of cash required from the common stockholders is generally larger than that demanded from the other security holders. In almost all instances where new cash is put into a reorganized company, the contributors get for this cash the best form of security that the company can provide. They may be given a security having priority over the securities issued in exchange for old first mortgage bonds Usually this security is a first mortgage on the property taken over in the reorganization.

The preferred stockholders are not the residual participants in the ownership of the company, as are the common stockholders, and therefore they enjoy a better strategic position in the reorganization negotiations. They may pay an assessment and they may be given common stock instead of preferred stock. In other words, their claim of precedence in principal and income may be moved back If that is done, they would ordinarily be given common stock more nearly equal in amount to the par value of their holdings than was

[3] In a report on a plan for the reorganization of The Gross-Pfleger Tanning Corporation, referred to the Securities and Exchange Commission pursuant to Chapter X of the Bankruptcy Act, the Commission stated "The right of a class of security holders to participate in a plan of reorganization should depend upon whether the value of the enterprise shows the existence of an equity for that class Where there is no equity for a particular class, holders of securities of that class should not be accorded participation unless they make a fresh contribution to the enterprise in money or money's worth" (S. E. C Reorg Release No 13, June 16, 1939.)

the amount which the common stockholders received. Sometimes the preferred stockholders are given part preferred and part common in exchange for their old holdings.

In some industrial companies, one of the difficulties has been to get rid of accumulations of dividends on cumulative preferred stock. The preferred stockholders cannot be expected to surrender their arrearages gratuitously. But they may do one of these three things: (1) accept securities for the arrearages, that is, the arrearages may be capitalized; (2) accept securities with a higher rate of preference but without the cumulative feature, that is, exchange a degree of certainty for a chance of greater income; and (3) get a greater degree of certainty, for which they will surrender an amount of income, that is, they may accept bonds bearing a lower rate of income than the stated preference on the stock.

General creditors.—The general creditors are those who have no specific liens on the company's property. If a creditor has a specific lien on property, his position in the reorganization will depend not only on the priority of his lien, but also on the value of the property to the company. If he has no lien at all, he is a residual claimant coming in ahead of the owners or stockholders. Under certain circumstances, however, he may come in ahead of the mortgage bondholders.

1. General creditors of railroad and other quasi-public corporations in equity receiverships, who became creditors within a reasonable time before a receiver was appointed in the belief that they would be paid out of earnings, receive a preference over the mortgage bondholders. This principle is known to lawyers as the principle of Fosdick v. Schall, and applies only to quasi-public companies such as railroads, electric power companies, and the like.[4]

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[4] This rule is a purely equitable principle that has given the courts much trouble See W M Fletcher, "Cyclopedia of the Law of Private Corporations," Vol 16, §7957 *et seq*, and "Some Legal Phases of Corporate Financing, Reorganization and Regulation," by Stetson, *et al*, 1917 edition, page 121 The rule rests on the theory that a receiver ordinarily is not appointed till a reasonable time after a company becomes insolvent Between the beginning of the insolvency and the appointment of the receiver, the property actually belonged to the old creditors Therefore, material men, laborers, and others, who furnished goods or services, actually were giving credit to the old creditors. The rule then rests on the principle that the material men and laborers have a first share in the assets because they are creditors of the creditors

2. Creditors who furnished to the receiver services or materials necessary to keep the property in operation may be given priority over the bonds.

3. Certain creditors may be given preference by local statutes, such creditors usually include laborers who are given priority for wages not to exceed an amount named in the statute.

Creditors who are included in one of these classes are usually paid in cash, although in certain cases some of them may be induced to accept first-class securities in payment for their claims.

Sometimes the general creditors may be classified in accordance with the method in which their claims arose, and the classification may be recognized by a statute, or it may call for some recognition in the reorganization plan. Thus, depositors of an insolvent bank are usually given a special claim against the stockholders. Policy holders of insurance companies may be treated in one way if their policies have matured (for example, if the insured has died, or if an insured building has burned) and may be asked to take a less favorable settlement if their policies have not matured. In a street railway reorganization, the so-called "tort creditors"—those who have been injured in accidents—may form a committee to insure reasonable treatment, and even this class may break up into two classes, those who have reduced their claims to judgment and those who have not.[5]

It has been held by the courts that a reorganization followed by a foreclosure cannot wipe out the general unsecured creditors if it permits stockholders to participate.[6]

As was indicated above, the claims of general creditors who have no special claim against any particular property

[5] Those with judgments are ordinarily in much better position than those who have claims that have not been reduced to judgment.

[6] The principle, based on the Boyd case (Northern Pacific Co. v. Boyd, (1913) 228 U. S. 482) is being applied to railroad reorganizations under Sec. 77B. The history of this doctrine is interesting and has been briefly recounted by Paul D. Cravath in "Some Legal Phases of Corporate Financing, Reorganization and Regulation," 1917 edition:

The Northern Pacific Railway Company was reorganized about twenty years ago. . . . . . No provision was made in the plan for the floating debt, which was considerable.

A committee of unsecured creditors sought to defeat the foreclosure suit upon the ground that it was the result of a conspiracy between bondholders and stockholders to exclude the floating debt and to turn over the valuable equity in the property to the stockholders. This effort was unsuccessful, the Circuit Court holding that the assets were insufficient to pay the mortgage debt and the net earnings insufficient to pay the fixed charges and that there was no equity in the property out of which unsecured creditors could be paid and that there was no reason why the mortgage bondholders in purchasing the property at foreclosure sale should not make any arrangements they chose for the participation of the old stockholders in the ownership

and who have no claim to priority under one of the principles enumerated above, are considered only one step better off than those of the stockholders. These creditors, therefore, cannot expect very favorable treatment in the reorganization plan. They are seldom asked to submit to a cash assessment, though this is possible if the property will not yield sufficient at the foreclosure sale to satisfy the mortgages. In the Westinghouse reorganizations of 1891 and 1907 the creditors were asked to make cash contributions. Frequently they are asked to take some low grade bonds, or even stock, in satisfaction of their claims.

Position of bondholders in reorganization.—The success of the maneuvers for favorable position in the reorganized company by the committees representing the bondholders will depend not only on the legal ranks of the bonds they respectively represent, but also on the value to the new company of the properties on which the bonds rest.[7] The situations in which committees may find themselves may be divided into the following classes:

1. Underlying mortgage on important property.
2. Underlying mortgage on unimportant property.
3. Senior mortgage on the main property.
4. Junior mortgage on important property.
5. Junior mortgage on important property and senior mortgage on unimportant property.

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of the stock of the reorganized company (Paton v Northern Pacific Ry Co, 85 Fed 838, 1896) No appeal was taken from this decision

The property was bought in at foreclosure sale by the bondholders' committee

About ten years after the consummation of this reorganization, the new Northern Pacific Company having in the meantime become highly prosperous, Boyd, the owner of a judgment for an unsecured claim against the old company, brought a suit against the old company and the new company, seeking to subject the property acquired by the latter from the former at foreclosure sale to the payment of his judgment He claimed that the foreclosure sale was invalid because it was made in pursuance of a Plan of Reorganization between bondholders and stockholders of the railroad company which made no provision for the payment of the unsecured creditors, although the stockholders retained their interest by receiving shares in the new company The Court below sustained this contention and entered a decree making Boyd's claim a lien upon the property of the old company in the hands of the new company, but subject to the mortgages placed thereon at the time of the reorganization The Supreme Court, by a vote of five to four, affirmed the judgment, the dissenters being Chief Justice White and Justices Lurton, Holmes and Van Devanter

The opinion of the majority of the Court proceeds upon the theory that while the bondholders might have lawfully bought in the property covered by the mortgage and kept it for themselves to the exclusion of both the unsecured debt and the stockholders, the moment they provided for participation in the new company by the stockholders, even at the price of paying a heavy assessment, the obligation arose to make provision for the unsecured debt which would recognize its priority to the interest of the stockholders

The prevailing opinion says. "This conclusion does not, as claimed, require the impossible and make it necessary to pay an unsecured creditor in cash as a condition of stockholders retaining an interest in the reorganized company His interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock If he declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it"

[7] See *Annals of Amer. Acad. of Pol & Soc. Sci.*, Vol 88, pages 23–33.

6. Junior mortgage on unimportant property.

Looking at the problem of the corporation itself, the point of departure is the value of the respective properties to the new organization. When this is determined, the next step is to deal with groups who have interests in those properties, with due regard to their legal position.[8] The simplest problem is the treatment of those holding claims exclusively on unimportant property If the property is an incubus—if it cannot be operated except at a loss—the reorganizers should take the opportunity which their proceedings offer to "lop it off"[9] If, however, the property is not altogether useless, the bondholders who rely upon it may be permitted to come into the reorganization on unfavorable terms. They may be required to pay an assessment and to take either a very small percentage of bonds in the new company, or stock[10]

We should observe, in passing, that in most reorganizations simplification of the financial plan is important and that the new company, therefore, is likely to have few separate bond issues. If, for example, the old company had six issues represented by the classes enumerated above, the new plan might call for two issues—a first and second mortgage issue on all the property. In such a case the holders of weak bonds of the old company would be given second mortgage bonds, and account would be taken of the relative weakness of the various issues of the old company by some adjustment of the amount of the assessment required from the several classes of securities and of the amount of bonds offered. Thus, one class may be asked to pay $20 for each bond held and be given sec-

[8] It must not be assumed that the problem is as simple as it is made to appear Dr Dewing, in his "Financial Policy of Corporations," is quite right in placing emphasis on the psychological elements that enter the reorganization negotiations The trouble is that these are not subject to close analysis. they bring a "catch as catch can" rule into the more scientific principles given above Much, for example, will depend on the financial affiliations of the principal bondholders represented by the various committees, on the astuteness and alertness of the negotiators, and on other similar factors

[9] The treatment of bonds resting on outlying properties does not depend to any great extent on the nature of the title which the corporation has to those properties The title may be held directly—that is, the bond may be a "divisional" bond, in railway language—or it may be held through a subsidiary company arrangement

[10] Where stockholders are required to take stock, they may be offered a larger par value of the poorer security than the par value of their holdings In the Wabash reorganization, a junior bond issue was offered second preferred stock equal to 120 per cent of the bonds.

ond mortgage bonds equal to 60 per cent of their respective holdings, whereas another class may be assessed only $10 and offered second mortgage bonds equal to 80 per cent of their respective holdings.

The same general principles apply to the security holders who have claims on the important properties. They will be asked to make small sacrifices, or they may be taken into the new company without any sacrifice whatever. Indeed, bonds secured by a first mortgage on a very strategic part of the property may come out of the reorganization in a better position than they went in. For example, the bonds may be low interest bearing bonds on which the interest was earned many times over. From an investment standpoint these securities have a superfluity of "safety" at the expense of "income." The holders, therefore, may be given an equal amount of par value of first mortgage bonds on the new property, bearing a higher rate of interest. Bonds in exceptionally good position will likely not be required to pay an assessment. Much will depend on the need for cash. If the insolvency is so bad that the stockholders can be given little incentive to participate in the reorganization, the bondholders will regard the property as belonging to themselves and thus will have to provide some of the cash.[11]

Reorganization of corporate systems.—The principles described above for determining the position security holders shall be given in the reorganized company apply also where more than one company is involved in the reorganization. To be sure, the more complicated the financial structure of a corporation and its affiliated companies, the more involved will be any reorganization due to the appointment of a receiver for the parent company or for any of its subsidiaries. If the parent company has run into financial difficulties because of the unprofitable operations of some of its subsidiaries, even the sound subsidiaries are likely to be affected by the reorganization. In the proposed reorganization of the Tri-Utilities Corporation in 1931, five subsidiary companies were involved in the plan although receivers had been appointed for the parent company and only two affiliated companies.

[11] See "Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization," by Bonbright & Bergerman, *Columbia Law Review*, February, 1928, for a summary of the departure from the absolute priority rights of the security holders in ten recent railroad reorganizations.

In the proposed reorganization, which contemplated the organization of a new company and a simplification of the system's capital structure, holders of preferred stock in the strongest subsidiary were offered, in exchange for their shares, prior preference stock in the new company and warrants to purchase common stock, whereas holders of preferred stock in the weak companies not only were offered stock junior to that which they had held, but were required to pay an assessment as well.

Receiver's certificates.—As was indicated on page 781, the court appointing a receiver has full right to place the lien of the receiver's certificates where in justice it belongs. Usually, the reorganization will provide for the raising of sufficient cash to liquidate these securities. In any event they ordinarily come out of the reorganization unscathed.

Cash for the new company.—We saw that a company going through reorganization needs cash for many purposes. The cash requirements in almost any fairly large reorganization are typical of what might be expected in other cases. For example, the cash requirements in the plan of reorganization of the Atlanta, Birmingham & Atlantic R. R. Co., 1917, were stated to be

Obligations of Receiver for equipment acquired during receivership, tax loans, claims and judgments, interest, etc	$1,105,491 52
To retire outstanding equipment obligations issued prior to receivership, with interest	930,237 50
Legal expenses of counsel for trustees in the foreclosure of the A B & A R. R, Georgia Terminal and Alabama Terminal R R mortgages and the sales thereunder	66,000 00
Reorganization expenses, including trustee's fees and disbursements, partly estimated	185,224 93
Compensation and expenses of Receiver's Certificates Committee in connection with the purchase and management of the properties, the organization of the New Company, the negotiating of the underwriting, etc	84,546 05
Compensation which may be allowed by the court to the Receiver and his counsel	112,500 00
Commission to syndicate managers and underwriting syndicate	216,000 00
To treasury of New Company for working capital, improvements and repair of equipment ($288,000)	900,000 00
Total	$3,600,000.00[12]

[12] To be acquired through sale of the $30,000,000 common stock of the New Company at $12 per share.

Cash funds for the new company are usually provided by (1) assessments, (2) sale of new securities, and (3) sale of assets.[13] In small reorganizations the creditors may even pledge themselves to grant certain lines of credit to the company on prescribed conditions—these conditions being that the company will be managed by certain people in a certain way; for example, it may be stipulated that the income shall be applied first to operating expenses and then to the payment of certain debts in a prescribed order.[14]

The securities that are to be sold, of course, must be of the very best character that the company can offer, otherwise no purchaser will be found; since the old security holders usually get the same sort of securities for the assessments paid, these assessments may be regarded as a forced sale.

Very frequently, some cash is raised through the sale of unnecessary assets It is not unusual for the investigation to reveal that the company has divided its attention between the production of several unrelated products, one or more of which it cannot handle profitably. Under such circumstances, wisdom dictates that the equipment, inventories, and goodwill connected with the unprofitable products be disposed of, and if possible, for cash In the autumn of 1923 the president of the American Cotton Oil Company sent to the stockholders a circular containing the following paragraph:

> When I assumed the presidency in May, 1923, I studied the affairs of the company and as a result I recommended that the company should proceed on the basic plan of expanding the profitable end of the business and curtailing that which has proved unprofitable In particular, I recommended to the directors that the manufacture and sale of "Gold Dust," "Fairy Soap," and other profitable products be pushed and that

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[13] Government lending agencies, which have been created by Congress from time to time for the purpose of stimulating and stabilizing the financial, commercial, and industrial enterprises of the nation, may prove a source of funds for companies in reorganization For example, some plans effected under Sec. 77B of the Bankruptcy Act (now Chapter X) have provided for the securing of loans from the Reconstruction Finance Corporation The reorganization plan of Propper-McCallum Hosiery Co, Inc provided for the obtaining of a $250,000 five-year 5 per cent loan from the RFC and the sale of new first preferred and new common stock. Additional funds were raised by the sale of certain of the company's assets.

Under the Reorganization Act of 1939, the Government independent lending agencies referred to above have been grouped under a Federal Loan Agency. The agencies so grouped include. the Reconstruction Finance Corporation, the Electric Home and Farm Authority, the Federal Home Loan Bank Board, the Federal Housing Administration and their associated agencies and boards, as well as the Export-Import Bank of Washington.

[14] See page 748.

the cottonseed oil business be curtailed The curtailment of the cottonseed oil business will mean that we can advantageously concentrate it into a few of our plants, rendering the balance unnecessary for our purpose The sale of these plants will not only relieve us of the burden of superfluous assets and heavy carrying charges, but will furnish us with cash toward meeting our $8,000,000 of notes maturing next September [15]

Underwriting a reorganization.—A reorganization plan usually will not succeed unless every part is carried out in full. The entire amount of cash calculated to be necessary must be forthcoming It is therefore usual, in important reorganizations, to have the financing underwritten. Thus, if the plan involves an offer of securities of the new company in accordance with rights to be issued to old stockholders, the underwriters will agree to purchase such new stock as is not subscribed for by the old stockholders. If the plan provides for the raising of cash by the sale of new securities to outsiders, in addition to an offering to old security holders, the underwriters may agree to purchase the new issue as well as the securities not subscribed for through exercise of rights.

Since old security holders cannot be forced to pay assessments—the alternatives are not pay or be sued, but pay or forfeit—plans involving cash contributions as a prerequisite to participation in the reorganization are usually underwritten. The syndicate agrees to pay the assessment for a given commission. For example, if a stockholder does not pay, the syndicate may be given the same rights that the stockholder would have had if he had paid the assessment, and this in spite of the fact that the syndicate had no stock in the old company.[16]

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[15] It was reported at about the same time that the company had disposed of about 20 of its 25 gins Also that its Memphis cottonseed oil mill had been purchased by the Dixio Cotton Oil Co, and that its plant at Waco, Texas, had been acquired by the Industrial Cotton Oil Co

[16] One reason for giving the syndicate the same position as old stockholders is revealed in the following excerpt from a notice sent out by the stockholders' protective committee of the International Steam Pump Co in 1915:

> When the time for the acceptance of the plan by stockholders shall have expired, the underwriting syndicate, formed by the joint reorganization committee to underwrite the cash requirements of the plan, will be entitled to all the new securities which, under the reorganization agreement, would have gone to the non-assenting stockholders had they assented to the plan, so that thereafter non-assenting stockholders could be admitted to participation in the plan only with the consent of and upon terms imposed by the underwriting syndicate There has been no intimation that such consent will be forthcoming. The committee, therefore, deems it only fair to stockholders to point this out in order that they may appreciate their peril in case they fail to assent to the plan on or before Monday, September 15 There seems no escape from the conclusion that stockholders who do not participate in the reorganization will lose their entire investment

In all cases, both as to the assessments and as to the new securities, the commission of the syndicate will depend on the risk run. In the case of the assessments, the risk will depend largely on the severity of the reorganization plan. If the paring down of rights is not drastic and the assessments are not heavy, the security holders who do not come in will be few and the syndicate will have little cash to put up. Where the plan is drastic, the risk will be great and the commission necessarily higher.

Sometimes the syndicate will offer to lend to the security holders money with which to pay their assessments. The following news item indicates the procedure.

> Provision has been made by the Western Pacific Railway reorganization committee, through the syndicate which has underwritten the plan, to facilitate subscription by holders of the first mortgage bonds to the $20,000,000 first mortgage 5 per cent bonds to be issued by the operating company Bondholders may subscribe to the new bonds at 90 to the extent of 40 per cent of their present holdings and will receive a bonus of 55 per cent in new preferred stock, and 95 per cent in new common
>
> Present earnings show a substantial surplus over interest requirements of the new bonds. The cash to be raised under the plan is to be devoted to purposes which should increase the earning power The underwriting syndicate offers to lend to subscribing bondholders 90 per cent of the purchase price of their subscriptions for one year at 6 per cent. Bondholders will put up as collateral all the securities received in the reorganization It is stated on authority that nearly $42,000,000 bonds out of the total outstanding issue of $50,000,000 have been deposited with the Equitable Trust Co.

It may be added that the syndicate probably borrowed from some bank the funds with which to make the loans The loan of the bank, in such a case, is secured by the securities themselves and by the personal obligations of the subscribers and the members of the syndicate.

How drastic can a plan of reorganization be?—The committees charged with the construction of a reorganization plan must always keep in mind that they are working out a compromise between what ought to be done and what can be done. A thoroughgoing surgical operation may be advisable, provided the patient can stand it. The question then arises: what can the patient stand? Any suggested plan must apply to each class of security the test of expediency: will these bondholders or will these stockholders see in the plan any encouragement to send good money after their bad money? For example, the common stockholders may be asked to pay

an assessment of $20 a share, for which they will be given $20 in new 5 per cent first mortgage bonds and common stock in the new company equal to 50 per cent of their present holdings. If the bondholders have made little sacrifice, and if the reorganized company is likely to have such a burden of fixed charges that the chances of dividends on the common stock are negligible, the common stockholder will probably prefer to count his old investment a total loss and to invest his $20 to better advantage elsewhere.

Voting trusts in reorganizations.—Even if all the financial factors are satisfactorily provided for in a reorganization, there always remains the problem of management. The syndicate that underwrites the reorganization and the sale of new stock will be compelled to reduce its own risk of having to supply all the cash, by convincing old stockholders and prospective investors that the causes of the insolvency have been removed and that they are not likely to recur. The plan, therefore, may provide that upon consummation of the reorganization agreement, the stock will be deposited under a voting trust agreement. In reorganizations consummated under Chapter X of the Bankruptcy Act, the method by which the voting trustees are to be chosen must permit adequate representation of those whose investments are involved in the reorganization.

An example of a reorganization.—The following is an example of a trustee's plan of reorganization of a corporation which filed a petition for reorganization under Sec. 77B of the Bankruptcy Act (now Chapter X). Since the company is insolvent, holders of the present preferred and common stock are not entitled to vote upon the plan and have no interest in the reorganized company. The student who has read carefully the explanation of reorganization under Chapter X of the Bankruptcy Act, on pages 766 *et seq.*, will observe how closely the plan follows the requirements of the statute.

PLAN OF REORGANIZATION OF NATIONAL RADIATOR CORPORATION PROPOSED BY WILLIAM G. HEINER, TRUSTEE, IN THE FORM APPROVED BY THE COURT MARCH 17, 1939.

I. General Statement.

National Radiator Corporation (hereinafter sometimes called "the Debtor") on March 19, 1938 filed in the District Court of the United States for the Western District of Pennsylvania, at No. 20155 in Bankruptcy, its Petition for

Reorganization under Section 77B of the Federal Bankruptcy Act, as amended; and William G Heiner, of Pittsburgh, Pa , and C Lawrence Evans, of Johnstown, Pa , were on March 19, 1938 temporarily appointed Trustees of the Debtor by order of said Court, and on April 18, 1938 said appointment was made permanent by further order of said Court

National Radiator Corporation (petitioner in the above entitled proceedings) was incorporated under the laws of Maryland on August 16, 1932, and was formed to take over the business and assets of the former National Radiator Corporation (of Delaware) The prior Delaware corporation was incorporated on June 25, 1927, to acquire as the result of a merger the business and assets of various radiator and boiler manufacturing companies, including the original National Radiator Company (of Pennsylvania) The companies included in the merger of 1927, and the location of the major manufacturing properties acquired as an incident thereto, were

NATIONAL RADIATOR COMPANY
Manufacturing plants at Johnstown, Pa , Trenton, N J , and New Castle, Pa

UNION RADIATOR COMPANY
Manufacturing plant at Johnstown, Pa

NIAGARA RADIATOR AND BOILER COMPANY
Manufacturing plants at North Tonawanda, N. Y , and Chicago, Ill

CONTINENTAL HEATER CORPORATION
Manufacturing plant at Dunkirk, N Y

GURNEY HEATER MANUFACTURING COMPANY
Manufacturing plant at Framingham, Mass

UTICA HEATER COMPANY
Manufacturing plant at Utica, N Y

The transfer of the business and assets of the above companies took place on August 30, 1927, with the exception of the Continental Heater Corporation which was acquired on August 5, 1927 The plant of the former Utica Heater Company, acquired in the merger, was subsequently sold at December 31, 1927, including the warm air furnace business, all of the other major properties being retained and still owned by the Debtor

The original National Radiator Company (of Pennsylvania) had, during the years prior to 1927, established a sound and profitable business and attained an excellent reputation in the industry The merging of the several companies in 1927 was expected to result in substantially increased sales volume and to permit the effecting of economies in production, distribution, selling, and administration, as well as to achieve a more commanding trade position

The business of the Debtor and its predecessor has fluctuated with the volume of building construction, which controls the demand for boilers and radiators Following almost immediately after 1927, and reaching its culmination subsequent to 1930, the construction volume declined rapidly, and it became necessary to close several of the plants, some of which have never been reopened for manufacturing purposes National Radiator Corporation (of Delaware) defaulted in interest on its funded debt in 1931, and this in turn led to receivership and ultimately to reorganization and the formation of the present Maryland corporation The operation by the Receivers of the properties of the Delaware corporation was discontinued at the transfer of the assets to the Maryland corporation on September 26, 1932, but protracted litigation at the instance of minority interests culminating in the decision of the Supreme Court of the United States in First National Bank of Cincinnati, et al., petitioners, v Florsheim, et al , decided January 8, 1934, served to delay the consummation of the reorganization for a considerable period of time and, to some

extent, financially to embarrass the reorganized company Conditions in the building industry generally and in the radiator business in particular further served to deplete the working capital of the reorganized company, with the result that the present proceedings for reorganization were instituted on March 19, 1938 A certified balance sheet of the Debtor as of the close of business March 18, 1938, prepared by Main and Company, accountants and auditors, is hereto attached, made part hereof, and marked Exhibit "A"

On October 26, 1938 the District Court of the United States for the Western District of Pennsylvania entered in the above-entitled proceedings an order authorizing and directing William G Heiner, one of the Trustees of National Radiator Corporation, to prepare and file in said proceedings on or before December 5, 1938 a Plan of Reorganization or a report of his reasons why a Plan of Reorganization could not be effected In pursuance of said order William G Heiner, Trustee, on December 3, 1938 filed in said proceedings a proposed Plan of Reorganization of National Radiator Corporation, which by further order of said Court was referred to Watson B Adair, Esq, as Special Master, for hearing thereon and to report, *inter alia*, his findings and recommendations with respect to said Plan and any objections which might be made or such amendments or plans as might be proposed by the Debtor or by any creditor or stockholder Such report of said Special Master was filed in said proceedings on January 18, 1939

This is the aforesaid Plan proposed by William G Heiner, Trustee, with certain modifications proposed by said Trustee in the course of the hearings before said Special Master, and suggested by the report of said Special Master, after giving consideration to objections and suggestions by parties in interest with respect to said Plan as originally proposed and filed by him

II Definitions

The following terms whenever used in this Plan of Reorganization, except where otherwise indicated by the context, shall have the following meanings respectively

Plan This Plan of Reorganization, including any and all modifications thereof

Debtor or Corporation National Radiator Corporation (a Maryland corporation)

Bankruptcy Act An Act entitled, "An Act to Establish a Uniform System of Bankruptcy throughout the United States," approved July 1, 1898, and Acts amendatory thereof and supplementary thereto, including the so-called "Chandler Act," being Act No 696 of the 75th Congress, Third Session, approved June 22, 1938

Court District Court of the United States for the Western District of Pennsylvania

Debentures Fifteen-Year Five Per Cent Income Debentures of National Radiator Corporation dated as of March 1, 1931, and issued and outstanding under Indenture from National Radiator Corporation to Manufacturers Trust Company, a New York corporation, as Trustee, dated September 27, 1932

General claims Claims against the Corporation filed in the above proceeding and duly allowed, excepting claims in respect of Debentures and excepting claims which either are entitled to priority as a matter of law or are secured by assets of the Corporation

Unsecured creditors Holders of Debentures or of general claims

Present preferred stock \$7 00 preferred stock of the Corporation, without par value, presently issued and outstanding

Present common stock Common stock of the Corporation, without par value, presently issued and outstanding

Stockholders Holders of either present preferred or present common stock of the Corporation

New Common Stock The New Common Stock described in Article IV of the Plan

Trustees William G Heiner and C Lawrence Evans, Trustees of National Radiator Corporation, or their successors duly appointed in the aforesaid proceedings

III The Reorganized Company

A It is proposed that upon confirmation of the Plan the Trustees shall organize a new corporation under the laws of such state as they may determine, having the name of "National Radiator Corporation" or a substantially similar name, and having an authorized capital in accordance with the provisions of the Plan As an incident to the consummation of the Plan, it is proposed to transfer and convey to such new corporation, excepting in so far as the Plan expressly provides otherwise, all of the properties and assets of every nature and description and wheresoever situated then owned or held by the Debtor or by the estate in the hands of the Trustees Said new corporation is hereinafter referred to as the "Reorganized Company" All matters in connection with the organization of such new corporation shall be determined by the Trustees with the approval of the Court

In the alternative, if the Trustees with the approval of the Court shall so determine, the operations of the Corporation after its reorganization may be continued under its Certificate of Incorporation issued by the State of Maryland on the 16th day of August, 1932, and under which it has operated continuously since that time In such event, following the confirmation of the Plan, the Certificate of Incorporation and By-Laws of the Corporation will be amended in such particulars as are deemed necessary or appropriate by the Court in order to consummate the Plan; and the term "Reorganized Company," as used herein, shall be deemed to refer to the existing Corporation as reorganized in accordance with the Plan

B The Reorganized Company will at the date of reorganization have no funded debt On the basis of the *pro forma* balance sheet of the Reorganized Company giving effect to the Plan (Exhibit B), tentative assurances have been received from commercial banks that the credit required by the Reorganized Company in its first year of operations can be obtained

C. The capital structure of the Reorganized Company, as contemplated by the Plan, is as follows.

New Common Stock·	Amount in Par Value	No of Shares
To be authorized	$2,000,000	200,000
To be issued under the Plan (approximately)	$1,530,560	153,056
To be subject to issuance for other corporate purposes (approximately)	$ 469,440	46,944

A *pro forma* balance sheet of the Reorganized Company is hereto attached, made part hereof and marked Exhibit "B"

IV. Description of New Common Stock

The 200,000 shares of New Common Stock of the Reorganized Company will have a par value of $10 each, and will carry voting privileges to the extent of one vote for each share The by-laws of the Reorganized Company shall provide for cumulative voting for the election of directors Approximately 153,056 shares of such New Common Stock will be issued under the Plan, and the remainder of the authorized New Common Stock may be issued by the Reorganized Company from time to time at not less than its par value in accord-

ance with applicable law, and subject to the obligation of the Reorganized Company to first offer such remaining shares to the holders of New Common Stock issued under the Plan

V Treatment of Present Creditors

A Claims Not Affected by the Plan

The claims of the following classes of creditors will be assumed by the Reorganized Company and paid in full in cash following consummation of the Plan:

(1) All costs and expenses of administration and other allowances which may be approved or made by the Court

(2) Indebtedness and liabilities heretofore or hereafter incurred by the Trustees during the trusteeship and remaining unpaid at the date of final confirmation of the Plan

(3) All claims of the United States or of any State or political subdivision thereof covering unpaid taxes or governmental charges; as well as any other claims entitled to priority of payment under applicable laws

(4) All claims the payment of which is secured by assets of the Corporation.

(5) General claims of $25 or less in amount

(6) Customers' credit balances as of the close of business March 18, 1938

B Claims and Securities Affected by the Plan

The following claims against and securities of the Corporation will be modified and altered by the Plan.

(1) General claims exceeding $25 (approximately $362,833 92).

(2) Claims of the holders of $4,536,207 89 principal amount of Debentures, aggregating with accumulated and unpaid interest thereon to and including March 18, 1938, the sum of $6,080,717 78.

C Basis of Exchange of General Claims and Debentures for Cash and/or Securities

Claims of Holders of Debentures.

In exchange for each of the Fifteen-Year 5% Income Debentures of the Corporation issued under Indenture from the Corporation to Manufacturers Trust Company, Trustee, dated as of September 27, 1932, together with all coupons appurtenant thereto and maturing on September 1, 1938 and thereafter, the Debenture holders will receive shares of New Common Stock on the following basis:

Debenture Denomination	Computed claim with interest to March 18, 1938	No of Shares of New Common Stock to be Issued
$1000	$1310 48	32
$500	$670 24	16
$250	$335 12	8

By their terms the coupons appurtenant to the Debentures, except the final coupons, become void at their respective maturity dates if no interest then shall be payable thereon; and the final coupons cover all arrearages of interest from March 1, 1931 to their maturity on March 1, 1946 Accordingly, failure to surrender coupons due March 1, 1938, or prior thereto, shall not affect the treatment to be accorded the Debenture holders hereunder, but all such coupons shall be deemed to be void

General Claims Exceeding $25 and Not Exceeding $500

The holders of general claims exceeding $25 and not exceeding $500 (excepting the aforesaid customers' credit balances) shall receive in exchange therefor, at their option, either

(a) One share of New Common Stock for each $40 00 involved in such claims, respectively, and for balances of such claims of less than $40 00 one additional share of New Common Stock will be issued, but only upon written demand of the holder of any such claim made upon the Trustees within ninety (90) days after the date of the Order of the Court confirming the Plan, and upon payment of that proportion of the sum of $10 which the difference between such balance and $40 00 bears to $40 00, or

(b) Cash in an amount equal to twenty-five (25%) per centum of such claims, respectively, or the sum of $25, whichever of said amounts may be higher

Any holder of any such general claim exceeding $25 and not exceeding $500 (excepting the aforesaid customers' credit balances) who shall have failed to notify the Trustees in writing within sixty (60) days after the date of the Order of the Court confirming the Plan as to his election with respect to the foregoing alternative methods of treatment, shall receive shares of New Common Stock in accordance with option (a) set forth above

General Claims Exceeding $500

The holders of general claims exceeding $500 (excepting the aforesaid customers' credit balances) shall receive in exchange therefor one share of New Common Stock for each $40 00 involved in such claims, respectively For balances of such claims of less than $40 00 one additional share of New Common Stock will be issued, but only upon written demand of the holder of any such claim made upon the Trustees within ninety (90) days after the date of the Order of the Court confirming the Plan, and upon payment of that proportion of the sum of $10 which the difference between such balance and $40 00 bears to $40 00

Summary

In pursuance of the contemplated exchanges and cash payments above mentioned, there will be distributed and paid to the unsecured creditors of the Corporation (assuming that all the holders of claims exceeding $25 and not exceeding $500 will elect to receive cash under option (b) set forth above) substantially the following amounts of New Common Stock and cash

To Holders of	Cash	New Common Stock
Debentures in respect of principal and interest	None	145,158 shares
General claims of $25 or less (approximately)	$3,148 66	None
General claims exceeding $25 and not exceeding $500	$13,666 37	None
General claims exceeding $500 (approximately)	None	7,898 shares
Customers' credit balances	$ 8,069 25	None
Total	$24,884 28	153,056 shares

VI. Basis of Treatment of Stockholders.

This Plan is predicated upon the insolvency of the Corporation at March 18, 1938, the day prior to the appointment of the Trustees in this proceeding, and at the present time. In the judgment of the Trustee such insolvency is clearly established by the operating reports of the Trustees and by the balance sheet

of the Company at said date as set forth in the audit report of Main & Company, certified public accountants, filed of record in these proceedings, as supplemented by the appraisals of the American Appraisal Company filed of record in these proceedings on November 12, 1938, and December 16, 1938, as well as by other evidence in the record of the hearings on the question of the insolvency of the Debtor held before Watson B Adair, Esq, Special Master, on December 16, 1938, and on January 7, 1939 It is proposed to request the Court, as a part of its order approving this Plan, pursuant to Section 174 of Chapter X of the Bankruptcy Act, to find that the Debtor is insolvent, and that neither the present preferred stock nor the present common stock of the Debtor is affected by the Plan in such manner or to such extent as to require the holders thereof to accept the Plan as a prerequisite to its confirmation and consummation The holders of the present preferred and common stock of the Debtor will accordingly have no interest whatever in the Reorganized Company

VII Retention and Disposition of Properties.

A PROPERTY DEALT WITH UNDER THE PLAN

The property dealt with under this Plan includes all of the properties and assets of the Debtor and of the Estate in the hands of the Trustees of every nature and description and wheresoever situated All claims belonging to the Debtor or to the Estate which are not collected by the Trustees prior to the consummation of the Plan shall be and become the property of the Reorganized Company, excepting claims not settled or adjusted in the Plan which shall be retained and enforced by the Trustees

B ACQUISITION OF PLANT AND PROPERTY OF SUBSIDIARY COMPANY

As an incident to the consummation of the Plan the Lebanon Plant and equipment therein owned by National Steel Boiler Company, a wholly-owned subsidiary of the Debtor, and leased to the Debtor, will be transferred and conveyed to the Reorganized Corporation together with such of the other assets of said subsidiary as may not be required for the payment of its obligations

C DISPOSITION OF IDLE PLANTS AND PROPERTIES.

The merger of various small radiator companies to form National Radiator Corporation (of Delaware) resulted in its acquisition of a number of plants and properties, large as well as small, which are now the property of the Debtor and some of which have been idle for a long period of time and cannot in all probability be profitably operated in the future The economies resulting from mechanization in manufacturing operations, and the concentration thereof at as few plants as possible, as well as the high cost of carrying such idle properties, dictate the advisability of disposing of such properties at as early a date as may be practicable There is attached to this Plan as Exhibit "C" an excerpt from the appraisal report of National Radiator Corporation (of Maryland) at March 18, 1938, as made by the American Appraisal Company and filed in this proceeding, and which describes generally the various properties of the Debtor and their relative usefulness in its operations

As an incident to the reorganization of the Debtor any or all of the following plants and properties now owned by it, in whole or in part.

Union Plant—Johnstown, Pa
Trenton Dwellings—Trenton, N J.
Chicago Plant—Chicago, Ill
Framingham Plant—Framingham, Mass
Dunkirk Plant—Dunkirk, N Y
North Tonawanda Plant—North Tonawanda, N Y.
Garden City Warehouse—Garden City, L. I, N. Y.

may, in the discretion of the Trustees, after confirmation of the Plan by the Court, be conveyed by the Debtor and the Trustees to a new corporation to be formed by the Trustees In exchange for the plants and properties so conveyed said new corporation shall issue to the Reorganized Company shares of its capital stock, so as to become at the date of reorganization a wholly owned subsidiary of the Reorganized Company, and as an incident to such conveyance such new corporation may assume and agree to pay any lien or encumbrance then existing upon any of the properties conveyed, and/or any unpaid taxes or governmental charges applicable to such properties. The name, state of incorporation, capitalization and all other matters in connection with such new corporation and such conveyances shall be determined by the Trustees

VIII Management of Reorganized Company.

The Reorganized Company shall be managed by a Board of Directors of not more than eight members, who shall exercise such powers and authority as the by-laws may prescribe The first Board of Directors shall consist of eight members, who shall take office upon the consummation of the Plan, and shall serve until the annual meeting of the shareholders of the Reorganized Company in the year 1941, and until the election and qualification of their successors

The members of the first Board of Directors shall be the following.

Name	Residence
Charles L. Crouse	Johnstown, Pa.
C. Lawrence Evans	Johnstown, Pa
Rudolph B Fleishem	Buffalo, N Y
William G Heinor	Pittsburgh, Pa
Leo J. Larkin	New York City, N Y.
Thomas B McAdams	Baltimore, Md
Arthur B Van Buskirk	Pittsburgh, Pa
Robert S Waters	Johnstown, Pa

The by-laws of the Reorganized Company may provide for an Executive Committee of the Board of Directors, consisting of not less than three nor more than five members thereof selected by the Board of Directors, who shall between meetings of the Board of Directors exercise and enjoy all of the power and authority of the Board of Directors in the management and business of the Reorganized Company, excepting in so far as the Board of Directors may otherwise prescribe, and the by-laws may provide that in the absence of any regular member of the Executive Committee any director may at the request of the President sit as a member of said Committee at any regular or special meeting thereof In so far as any and all matters having relation to said Committee may not be governed by the by-laws they shall be subject to appropriate action of the Board of Directors

Immediately following their taking of office hereunder, the first Board of Directors shall elect a President, one or more Vice Presidents, a Secretary, and a Treasurer, and such other officers as the by-laws may prescribe, to serve at the pleasure of said Board of Directors until the annual meeting of the shareholders in 1941

At each annual shareholders' meeting beginning with the annual meeting in 1941, the shareholders of the Corporation shall elect a Board of Directors for the ensuing year in accordance with the by-laws of the Company

IX. Certificate of Incorporation of Reorganized Company.

There shall be included in the certificate of incorporation of the Reorganized Company, by appropriate amendments or otherwise:

(a) Provisions prohibiting the Reorganized Company from paying cash dividends except out of net profits or surplus earnings realized after the date of consummation of the Plan, as determined in accordance with sound principles of accounting consistently maintained

(b) Provisions prohibiting the Reorganized Company from issuing non-voting stock

(c) Provisions requiring the Reorganized Company to make, not less than once annually, periodic reports to its security holders, which shall include profit and loss statements and balance sheets prepared in accordance with sound business and accounting practice

(d) Provisions preserving the preemptive rights of the holders of New Common Stock issued under the Plan to subscribe for the remainder of the authorized New Common Stock provided for in the Plan

(e) Such other provisions as are necessary or appropriate in the opinion of the Court, and as may be prescribed in its order confirming the Plan or in any other decree, in order to carry out the Plan or to comply with any provision of law

X Approval, Acceptance, Confirmation and Consummation of Plan

This Plan shall be approved, accepted, confirmed and consummated in accordance with the provisions of Articles VII and XI of Chapter X of the Bankruptcy Act, as amended No provision is made for the realization by the unsecured creditors (which is the only class of creditors affected by the Plan) of the value of their claims against the property dealt with by the Plan and affected by their claims, for the reason that the acceptance of the Plan by two-thirds of such unsecured creditors as a class is essential to the confirmation of the Plan, and if the Court should determine that there is more than one class of creditors affected by the Plan, and if any such other class does not accept the Plan by the requisite two-thirds majority, then the Court in its order confirming the Plan may, in accordance with the provisions of the Bankruptcy Act, prescribe the protection which such non-consenting creditors are to receive

XI Execution of the Plan

Upon its confirmation, the Plan shall be executed and consummated by the Trustees, acting under the supervision of the Court For such purposes the Trustees shall have full power and authority to take any and all steps deemed by them to be necessary or proper to effect and to consummate the Plan, and which may be authorized or approved by the Court, including, inter alia —

(a) The determination of the provisions of the charter of the Reorganized Company, or of any amendments thereto, necessary or appropriate in order to carry out the Plan

(b) The determination of the provisions of the by-laws of the Reorganized Company, or of any amendments thereto, necessary or appropriate in order to carry out the Plan.

(c) The transfer and conveyance to any new corporation formed for the purposes of the Plan, as provided in Article III hereof, of the properties and assets of the Debtor or of any subsidiary company, or in the hands of the Trustees, and the determination of all matters incidental thereto

(d) The determination in accordance with the Plan of the provisions of the certificates for New Common Stock

Distribution of cash and/or New Common Stock shall be made by the Trustees to creditors (a) proofs of whose claims have been filed prior to the

date fixed by the Court and are allowed, or (b) if not so filed, whose claims have been scheduled by the Debtor as fixed claims, liquidated in amount and not disputed

In pursuance of their duties and responsibilities under this Article XI of the Plan, no notices shall be required to be given to the creditors or stockholders of the Company, unless the Court shall, with respect to any particular matter direct otherwise

Dated at Pittsburgh, Pa , February 4, 1939

Respectfully submitted,

WILLIAM G HEINER,
Trustee, National Radiator Corporation

ARTHUR B VAN BUSKIRK,
T W POMEROY, JR.
REED, SMITH, SHAW & MCCLAY,
Counsel for William G Heiner, Trustee

747 Union Trust Building,
Pittsburgh, Pa

Reconstruction for causes other than failure.—Reconstruction often occurs for some cause or causes other than failure. The more important of these causes may be enumerated as follows:

1. Dissolution because some law, such as the antimonopoly law, has been violated

2. Segregation of companies specifically required by law to dissolve their relationships An example of this form of reconstruction is furnished by the segregation of the coal and railroad companies under the Commodities Clause of the Interstate Commerce Commission Act. Another example is the simplification of public utility holding company systems to meet the requirements of the Public Utility Holding Company Act of 1935. (See page 697.)[18]

3. Recapitalization as a step preliminary to consolidation.

4. Recapitalization as a step preliminary to refinancing.

5. Recapitalization to get rid of arrearages of preferred dividends.

6. Reconstruction to get rid of unprofitable units.

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[18] See, for example of dissolution under Interstate Commerce Act, "Decree Approving Third Modified Plan of the Reading Company," filed in the District Court of the United States for the Eastern District of Pennsylvania, June 23, 1923. For example of voluntary reorganization under the Public Utility Holding Company Act, see Securities and Exchange Commission Release No. 961, Jan. 11, 1938, approving plan of Massachusetts Utilities Associated

7. Reconstruction to dispose of unnecessary corporate entity.

8. Reconstruction to give active management an interest in the ownership control.

9. Reconstruction to reduce taxes.

We shall proceed to discuss these subjects briefly, omitting, however, number 2, which is too specialized to warrant detailed explanation here.

Dissolution under anti-trust law proceedings—We saw in the chapter on illegal combinations the circumstances under which these intercorporate relations are prohibited as being monopolistic and in violation of the Sherman Anti-Trust Law Before the Federal Trade Commission was created, the procedure consisted of a decision of a lower Federal court condemning the combination, from which an appeal was almost invariably taken to the Supreme Court. If the lower court's opinion was affirmed, the matter was returned to the lower court for a decree instructing how the dissolution was to take place. The court was always mindful of the injuries that might result to innocent investors, and held hearings to give all parties an opportunity to advance their objections to suggested plans. This method of "unscrambling" the trusts took up so much of the court's time that the Federal Trade Commission was created, partly to work out plans of dissolution The final plan must have as its objects. (1) an effective restoration of competition among the parts into which the combination is broken up, and (2) as little injury as possible to the security holders [19]

Recapitalization as a step preliminary to consolidation.—We saw that intercorporate relations are frequently brought about through a purchase by one company of the assets or of stock of another. Before the purchasing company can deliver its securities for which the plan of consolidation provides, it may have to recapitalize.[20] Thus in 1915, when the Kennecott Copper Company bought stock of the Utah Copper

[19] For the important part of the decree dissolving the so-called Powder Trust, see C. W Gerstenberg, "Materials of Corporation Finance," pages 1001–8.

[20] The author uses the term recapitalization for some change in the form of capitalization not inspired by failure or fear of imminent failure Recapitalization also connotes that the change is not merely an increase in capital stock or bonds resulting from the normal expansion of a concern, and that it is not merely a stock dividend The change in capitalization may be the resu

Company, Braden Copper Mines Company, and the Alaska Syndicate, it had to increase its stock from 720,000 shares to 3,000,000 shares without par value. In 1918, when the American Glue Company purchased the National Glue Company, it increased its own stock first and then paid large stock dividends to its own stockholders before issuing stock to the vendor company.

The advantages of such an arrangement will be seen if a simple imaginary example is given. Let us suppose that company *A* has one class of stock—10,000 shares without par value but with a book value of $300 a share, or $3,000,000 for the entire stock. It proposes to buy company *B*'s property, *B* has outstanding 5,000 shares with a book value of $100 each. If *A* increases its stock to 15,000 shares in order to give *B* 5,000 shares, the book value of each of its shares will be $200 ($3,000,000 divided by 15,000). It could give *B* 2,500 of these shares, since the net value of *B*'s property is $500,000. This would mean that if company *B* wished to dissolve, it could give to its stockholders only one share of *A*'s stock for every two shares of its own stock. Perhaps the stockholders of *B* would not consent to the sale of their property in the first instance if they knew that their holdings, although of the same market or book value, were nominally to be cut in two. Some arrangement must be made whereby the *B* stockholders, in exchanging their shares for the stock of company *A*, can get share for share. The solution is to dilute the *A* stock till it has the same book value as the *B* stock. *A* therefore would increase its stock to 35,000 shares; it would declare a stock dividend of two shares for each outstanding share, thus using up 20,000 shares of the increase, the other 5,000 shares would be given to company *B*. The recapitalized combined company would have net assets amounting to $3,500,000, and each of its 35,000 shares would have a book value of $100.

Recapitalization as a step preliminary to refinancing.—On the same principle as was explained in the previous section, corporations sometimes are led to recapitalize before selling new securities to outsiders. The author has in mind a small

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of some necessity, as for example, where stock is issued to clean up arrearages of dividends on cumulative preferred stock in order that the company's credit shall improve sufficiently to permit it to sell other securities on favorable terms.

corporation whose purpose was to speculate in New York real estate. The opportunity came to buy a parcel of property at a time when all the funds were tied up in other properties. In order to treat its stockholders alike and still not to force them to subscribe to new stock to preserve their equity in the surplus, or to purchase stock at a premium, a stock dividend was first declared, bringing down the book value of all the outstanding stock to its par value.[21] When this had been accomplished, the purpose of the new issue (to raise cash to buy the new property) was explained and the stockholders were given an opportunity to purchase new shares at par.

Sometimes refinancing is thwarted because a company has in the past depended too much on bond financing. If, for example, a company issues bonds to such an extent that the interest eats up a large part of the earnings, and if the remaining earnings are "ploughed into" the property to furnish an equity in the improvements and betterments acquired through the sale of bonds, the stock will go year after year without dividends, its value will be depressed, and consequently there will be no market for new shares. Thus the company will be forced to issue more bonds whenever funds are needed. To obviate the difficulty, some plan will have to be devised for issuing securities with the contingent claim of dividends instead of the fixed claim of interest. The device of stock without par value has frequently solved the problem in recent years, for such stock can be sold at its market value without involving the holders in future liability, as would be the case if stock with a par value of $100 a share were sold at a price lower than par.[22]

Another way out is to issue preferred stock or to issue prior lien stock. Thus in 1914 the Pacific Gas and Electric Co. met the difficulty of a dangerously increasing dependence on bonds by making its preferred stock a second preferred issue to come after some new preferred stock, the latter in effect, therefore, became a prior lien stock.[23]

Recapitalization to get rid of arrearages of preferred dividends.—Sometimes a company will wish to sell additional

[21] If the reader will turn back to page 600, he will readily follow the argument in this sentence

[22] See *ante*, page 127

[23] For a copy of the official circular describing the transaction, see C. W. Gerstenberg, "Materials of Corporation Finance," pages 929–932. See *ante*, page 155

preferred stock for purposes of expansion, but will be handicapped in so doing because arrearages of accumulated dividends on the preferred will have depressed its market value. To clean up the arrearages, some form of recapitalization will be required; usually securities are substituted for cash in the payment of the arrearages For example, in 1917 the American Water Works & Electric Company increased its preferred stock by $5,000,000, of which $450,000 was to provide dividends for arrearages and the remainder was to be used for needed expansion. The 21 per cent arrearage, in that case, was paid by giving 3 per cent in cash, 9 per cent in preferred stock at par, and 9 per cent in common stock at 22½. Since these dividends were to be paid on $5,000,000 of preferred, the company had to issue $450,000 of preferred stock and $2,000,000 of common, par value.

In 1936 many corporations settled dividends that had accumulated during the depression by readjusting their capital structures and offering stockholders a small amount of cash and the balance in securities. For example, stockholders of Bethlehem Steel Corporation, Lehigh Portland Cement Company, and Pure Oil Company approved plans for settlement on this basis.

Reconstruction to get rid of unprofitable units.—A corporation may find that part of its business is unprofitable and should be discontinued. In connection with the liquidation of this unprofitable part, some form of recapitalization may take place. For example, in 1923 the American Cotton Oil Company found that the principal business for which it had been organized forty years previously—that of crushing cotton seed and refining and selling the resultant cotton seed oil—had become unprofitable. But its subsidiaries had been successful; they had been making the well-known products, Gold Dust and Fairy Soap. It therefore proposed to exchange its own stock for stock of the Gold Dust Corporation in order that the stock associated with the more profitable business would be outstanding in the hands of the investment public. This was an excellent move to improve the general investment position of the combination.

Reconstruction to dispose of unnecessary corporate entity.—After a concentrated period of expansion during which holding companies, operating companies, and other corporate entities have been used to acquire control of plants and to extend the

operations of a concern, the owners of the interlocking companies may find that their corporate structure is unnecessarily complicated and unwieldy Readjustment becomes necessary to simplify the organization. Thus, the directors of the General Baking Corporation, a holding company formed in 1925 which had acquired control of the General Baking Co and other companies, found in 1931 that there was no reason for continuing to maintain both the General Baking Corporation (the holding company) and the General Baking Co (the operating company), as the assets of the holding company consisted almost entirely of common stock of the operating company. In fact, the existence of the holding company had become a handicap to the operating company The capitalization of the holding company was unwarranted by the earnings of the corporation and if the company continued to pay dividends on its $6 preferred stock at the rate specified, the operating company would be unable to finance through earnings the requirements of the normal growth of its business. To remedy the situation, a plan was adopted whereby the holding company would be dissolved and the stockholders would receive in exchange for their preferred shares and for accumulated dividends in arrears, common stock of the operating company. A recapitalization of the General Baking Co. was necessary to permit the exchange of securities.

Reconstruction to give ownership control to the active management.—It is usually a good rule to let the active, responsible management control correspond quite closely to the technical ownership control. Thus subordinates will know that the orders coming from the management carry an air of finality. Let us suppose that *A* owned the controlling interest in company *X* and that upon his death the stock representing the control passed into the hands of his widow, who relied upon younger subordinates on whom are now thrust the responsibilities of active management. The widow would probably do well to accept preferred stock with proper protective features and to turn over common stock representing a residual claim on the earnings to the active managers. It is not necessary to make a present of the stock, the option to purchase at a reasonable price will induce loyalty and intelligent application to business on the part of the interested managers, who may be permitted, through some form of profit-sharing agreement, to apply a certain percentage of the earnings of the business

to the payment of the purchase price of their stock. Thus in 1917 the president of Marshall Field & Co. announced the reorganization of the management of the company and a division of the stock, giving the preferred to the Marshall Field estate and to the retiring officers, and the common stock to those who were actively to carry forward the administration of the business

Reconstruction for tax purposes.—In the beginning of this book we compared the various forms of business organization from the standpoint of their tax liability. In recent years taxes have increased tremendously. Even if Federal taxes are reduced, the State and local governments' demands for more income will probably mean a continuous increase in taxes levied on business income by government authorities Businesses organized in a form that is heavily taxed, or operating under charters from States whose taxes are relatively high, will be at a disadvantage when compared with competitors who have grasped at every legitimate opportunity to reduce taxes to a minimum. Every business should inquire, periodically, since the business will change constantly in volume and even in its nature and the location of its operations, whether certain steps cannot be taken to avoid heavy taxes or multiplicity of taxes. We cannot repeat the various suggestions made in the course of this book, but many of them, if advantage is to be taken of them, will require some form of reconstruction A corporation may be turned into an individual proprietorship, or vice versa; subsidiaries may be consolidated with the parent company, a concern may wish to reincorporate in a State where it will have lower annual taxes; it may wish to give up its charter in some foreign State, thus avoiding taxes there, and to incorporate in the State where it is doing its principal business and where it is taxed just as heavily as a foreign corporation as it would be taxed as a domestic corporation.

But whatever step is taken in reconstruction, whether it be on account of failure or for some other reason, care must always be exercised that the transaction is not technically carried out in a way that will incur unnecessary taxes. Certainly no reconstruction of any kind should be undertaken without a careful study of Sections 112 and 113 of the Internal Revenue Code and the Regulations and various rulings issued by the Treasury Department in interpreting this important

section. The subject is too technical and would take up too much space here for even a brief description of the principles involved, but again we urge all persons engaged in any form of reconstruction to study carefully not only the law, but all the illustrative cases that have been used by the Treasury Department in elucidating its interpretation of the law.[24]

[24] See the following headings in the index of the current Prentice-Hall Federal Income Tax Service reorganization, consolidation, liquidation, and so forth See also the Prentice-Hall State Tax Service for the tax laws of the several States

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